NOTES

REQUIREMENTS FOR FILING PETITION UNDER CHAPTER XI OF THE CHANDLER ACT*

CHAPTER X of the Chandler Act[1] was enacted to "democratize" corporate reorganizations of great size and complexity for protection of the investing public. In contrast, Chapter XI[2] was intended to operate primarily as an expeditious proceeding for both individuals and corporations directed toward reducing delay and expense of small-scale financial readjustments wherein the public interest plays a minor role.[3] Examination of the Act, however, discloses a perplexing deficiency in criteria for determining under which of Chapters X and XI a given corporate reorganization should properly be conducted.[4]

In the first "full-dress" case[5] to highlight the defective interrelation between the two chapters, United States Realty and Improvement Company, a large corporation with security issues widely held by the public,[6] filed a petition for an arrangement under Chapter XI. The debtor was the holding and management parent of real estate operating subsidiaries. Among them was Trinity Buildings Corporation, of which the debtor owned the entire capital stock. In 1919, for the purpose of facilitating sale of $7,000,000 worth of twenty-year first mortgage bonds of Trinity, Realty guaranteed the issue as to interest, principal and sinking fund payments. On the day preceding the date of maturity, when default upon $3,710,500 in bonds then outstanding was deemed inevitable, Realty filed under Chapter XI for an arrangement[7]

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* *In re* United States Realty & Improvement Co., C. C. A. 2d, Jan. 15, 1940.

1. BANKRUPTCY ACT, 52 STAT. 840, 11 U. S. C. §§ 1-1103 (Supp. 1938). Subsequent citations to the Bankruptcy Act will refer to the section number alone. Sections of Chapter X are numbered from 101 to 276. For a valuable section by section discussion of the Act, in convenient form, see WEINSTEIN, THE BANKRUPTCY LAW OF 1938 (1938).

2. Sections of Chapter XI are numbered from 301 to 399.

3. See Rostow and Cutler, *Competing Systems of Corporate Reorganization: Chapters X and XI of the Bankruptcy Act* (1939) 48 YALE L. J. 1334.

4. This deficiency appears to be generally recognized. See Rostow and Cutler, *supra* note 3; Levi, *Corporate Reorganization and a Ministry of Justice* (1938) 23 MINN. L. REV. 1, 25; Jackson, *The Need for Amendment of the Chandler Act* (1939) A3 CORP. REORG. 35.

5. *In re* United States Realty & Improvement Co., C. C. A. 2d, Jan. 15, 1940.

6. 899 individual investors held share certificates representing Realty's contingent liability on a guarantee of another corporation's bonds; 900,000 shares of its stock were outstanding, listed and traded in on the New York Stock Exchange. Moreover, the investing public held sizeable quantities of other debentures of the company.

7. The haziness of distinction between a "reorganization" (Chapter X) and an "arrangement" (Chapter XI) in the case of a large corporation attempting an extensive shake-up of its financial structure was apparent in the district court's interchangeable usage of these terms. Counsel for the debtor carefully emphasized the fact that it was seeking an "arrangement," by correcting the court's lapses in terminology. *In re* United

of its unsecured obligation on the guarantee.[8] Pleading inability to meet its debts as they matured, the debtor offered a plan whereby the maturity date of the certificates was to be postponed, the interest reduced and time for payment of part of the interest extended. As an adjunct to the plan, provision was made for a subsequent alteration in Trinity's primary obligation on the certificates parallel to that to be achieved in the guarantee under Chapter XI.[9] For this purpose Trinity was to be put through an entirely separate reorganization in the state court under the New York Burchill Act.[10]

The Securities and Exchange Commission appeared as amicus curiae at a session of the adjourned first meeting of creditors and urged the court to dismiss the petition on its own motion for lack of "jurisdiction."[11] After failure in this attempt, the Commission was granted leave to intervene for the limited purpose of contesting "jurisdiction." From orders denying its motion to dismiss and referring the proceeding to a referee, the SEC filed notice of appeal.[12] The debtor filed notice of appeal from the order allowing intervention, and, in addition, moved in the appellate court to dismiss the SEC's appeal. With one judge dissenting, the Circuit Court of Appeals for

States Realty & Improvement Co., Record on Appeal, p. 275 (hereinafter cited as Record on Appeal).

8. This timely application by the debtor for relief under Chapter XI effectually prevented its creditors from filing under Chapter X after default, since the Chapter XI court could not be ousted from jurisdiction by a subsequent petition. Graham v. Boston H. & E. R. R., 118 U. S. 161, 178 (1886); Michaels v. Post, 21 Wall. 398 (U. S. 1874). *Cf.* Rostow and Cutler, *supra* note 3, at 1370–71. Before default, neither proceeding was available to creditors, because Chapter XI is only voluntary, under all circumstances, and facts essential to support a creditor's petition under Chapter X did not exist. See §§ 126, 131, 321, and 322.

9. Assent to the plan was deemed to include acquiescence in alteration of Trinity's obligation; nevertheless, failure to achieve such alteration was not to affect the antecedent modification of Realty's guarantee. Record on Appeal, pp. 33, 34. Pursuant to its power to solicit acceptances even before filing of the petition, as conferred by § 336, the debtor obtained consents from more than the required 50% of the certificate holders before its application for confirmation of the plan. *In re* United States Realty & Improvement Co., Brief of SEC *re* Dismissal of Petition and Proceeding, p. 4, n. 7.

10. N. Y. REAL PROP. LAW §§ 119-123. The Burchill Act proceeding provides for reorganization through the device of a foreclosure and sale by the trustee under a mortgage bond indenture, conveyance of the property to a newly formed corporation in return for its securities, and distribution of such securities to participants in the reorganization. Certain procedural requirements must be followed to effect a plan; and, in the absence of dissent by over ⅓ of the bondholders, the plan becomes binding upon all.

11. The term "jurisdiction," as here used by the Commission and the court, seems to mean no more than the statutory propriety of the proceeding without reference to the availability of collateral attack. See Chicot County Drainage Dist. v. Baxter State Bank, 60 Sup. Ct. 317 (U. S. 1940), 49 YALE L. J. 959; Pennsylvania v. Williams, 294 U. S. 176, 181, 182 (1935); Vallely v. Northern Fire Ins. Co., 254 U. S. 348 (1920).

12. The Commission also moved to vacate the order continuing the debtor in possession and to deny confirmation of the proposed arrangement, and appealed from all four adverse rulings pursuant to provisions of §§ 24 and 25. For a discussion of these sections and their value in eliminating doubts surrounding appellate procedure in bankruptcy proceedings, see WEINSTEIN, THE BANKRUPTCY LAW OF 1938 (1938) 64–68.

the Second Circuit granted the debtor's motion and reversed the order of intervention.[13]

While, unquestionably, a Chapter X proceeding in the instant case would have been more consonant with the purposes of the Act,[14] Chapter XI more effectively served the interests of Realty's management. A well-founded fear that a forced sale of Trinity's mortgaged property would destroy the equity represented by Realty's holdings of stock in the subsidiary drove the debtor to this roundabout procedure. If the strict priority theory of the *Boyd* case[15] were applied in the Chapter XI proceeding, Realty stockholders would inevitably have been ousted from future participation in Realty's affairs.[16]

13. The same result was independently reached in a very similar case, decided shortly after the principal case. *In re* Credit Service, Inc., C. C. H. Bankr. Serv. ¶ 52,240 (D. Md. 1940). However, intervention was a less important issue in that case since "jurisdiction" was attacked by a large number of debenture holders, as well as by the SEC.

14. In *In re* Reo Motor Car Co., 30 F. Supp. 785 (E. D. Mich. 1939), the debtor, having filed voluntarily under Chapter X, moved late in the proceedings for transfer to Chapter XI. Although alternative grounds for denial of the motion were present, among them the fact that the plan had provided for modification of the capital stock, not permissible under Chapter XI, the judge nevertheless based his denial of the motion upon the theory that Chapter X was the proper chapter for corporations with publicly held securities. A similar result was reached in *In re* McKesson & Robbins, Inc., No. 72697 (S. D. N. Y. 1939), though the only outstanding indebtedness was unsecured. However, the debtor alleged therein that falsification of its books barred its discharge as a bankrupt and prospectively prevented confirmation of any arrangement under § 366 of Chapter XI. In *In re* Majestic Radio & Television Corp., No. 71680 (E. D. Ill. 1939) the improper petition of the debtor under Chapter XI was opposed by the SEC; but, on the judge's recommendation, to save time, transfer to Chapter X was made by agreement of the parties.

15. Briefly summarized, the rule of Northern P. Ry. v. Boyd, 228 U. S. 482 (1913), is that junior claimants may not participate in a reorganization until the holders of senior claims are fully compensated. For a detailed treatment of the rule, see Rostow and Cutler, *supra* note 3, at 1346–1352. Numerous decisions under old §§ 77 and 77B have held the words "fair, equitable, and feasible" to embrace the dictates of the *Boyd* case. Case v. Los Angeles Lumber Products Co., 60 Sup. Ct. 1, 8 (U. S. 1939). Hence, use of these words in Chapter XI as the test of a proper arrangement gives reason to suppose that, in light of the *Case* case, the *Boyd* doctrine will be applied to proceedings thereunder. However, inclusion in Chapter XI of the requirement that the arrangement must be "in the best interest of creditors," a test taken from the old composition § 12, casts some doubt upon the strict applicability of the *Boyd* case to proceedings under the Chapter. See note 16 *infra*. The SEC has taken a firm public stand supporting the strict priority theory. See Meck and Cary, *Regulation of Corporate Finance and Management Under the Public Utilities Holding Company Act of 1935* (1938) 52 HARV. L. REV. 216, 247; Speech of Samuel Clark, Chairman, Corp. Reorg. Div., SEC, before the "Practicing Law Courses," New York City, Jan. 5, 1939; Speech of J. Anthony Panuch, Special Counsel, Reorg. Div., SEC, before New York County Lawyers' Ass'n, New York City, Nov. 21, 1939.

16. In the dissenting opinion of the instant case, Judge Clark assumed that the *Boyd* doctrine would govern in Chapter XI. A similar view was taken in *In re* Credit Service, Inc., C. C. H. Bankr. Serv. ¶ 52,240 (D. Md. 1940). See Rostow and Cutler, *supra* note 3, at 1352–1362. Faced with seeming inconsistency between the strict priority theory of the *Boyd* case and the composition concept of Chapter XI, these authors nevertheless claim that both compositions and reorganizations represent an application to different fact situations of the same equitable principle of making available to creditors the greatest possible

But the courts have not yet applied the rule of the *Boyd* case in a Chapter XI proceeding; and the debtor had reason to believe that the court would not do so.[17] Normally the state court could be expected to hold the *Boyd* doctrine controlling in the Burchill Act proceeding brought to modify Trinity's primary obligation on the certificates,[18] thus barring participation of the debtor in the reorganization of the subsidiary.[19] However, the debtor hoped

portion of the debtor's assets. They argue that, in old § 12 compositions of small enterprises with their good-will embodied in individual owners, this equitable result was deemed achieved when creditors received their estimated share of a figurative liquidation, but that the same measure for distribution cannot be used where good-will may easily be made available to creditors, as in the case of larger corporations. If control or management has value for the creditors, it should be preserved for them. However, where the continuance of a corporate business is peculiarly dependent upon incumbency of the existing management, it may be regarded as "fair and equitable," and "in the best interests of creditors," to permit stockholder participation in the reorganization. *Cf.* Graham, *Fair Reorganization Plans under Chapter X of the Chandler Act* (1938) 8 BROOKLYN L. REV. 149-157. Although, in the instant case. a majoritv of certificate holders was amenable to continuance of the old management in control, this does not seem to have been indispensable to the future success of Realty to the extent necessary to induce application of the *Boyd* rule in the manner outlined above. See Record on Appeal, pp. 163, 164.

17. Application of the *Boyd* doctrine requires first and greatest sacrifice in reorganization from stock interests, for the modification of which Chapter XI makes no direct provision. Conceivably, "catch-all" § 357(8) may be interpreted to include such adjustment. But, since the chapters were drafted in parallel form, omission in § 357(1) of Chapter XI of the provision in § 216(1) of Chapter X permitting alteration of stock interests by issuance of new securities of any character, or otherwise, seems purposive. Courts have not yet had occasion to follow the suggestion advanced in note 16 *supra;* and it is more than likely that, with an eye to practice under the predecessors of Chapters X and XI, respectively old § 77B and § 12, creditors of insolvent corporations will receive somewhat more, and the stockholders somewhat less, under Chapter X than under Chapter XI. See Rostow and Cutler, *supra* note 3, at 1361, 1362. As further basis for this prediction, at least two cases under old § 12 involved composition of bonded indebtedness by a large corporation with securities widely held by the public. *In re* Realty Associates Securities Corp., 69 F. (2d) 41 (C. C. A. 2d, 1934); *In re* O'Gara Coal Co., 260 Fed. 742 (C. C. A. 7th, 1919). See also Mr. Justice Douglas's note 14 in Case v. Los Angeles Lumber Products Co., 60 Sup. Ct. 1, 9 (U. S. 1939), which indicates a definite line between composition and reorganization principles, but for the purpose of reaffirming applicability of the *Boyd* rule to 77B and Chapter X proceedings, rather than of answering the question in respect to Chapter XI.

18. New York decisions adopt the *Boyd* principle. Chase Nat. Bank v. 10 East 40th Street Corp., 238 App. Div. 370, 375, 264 N. Y. Supp. 882, 888 (1st Dep't 1933); Clinton Trust Co. v. 142-144 Joralemon St. Corp., 237 App. Div. 789, 793, 263 N. Y. Supp. 359, 364 (2d Dep't 1933); Rice v. Pound, 153 Misc. 226, 274 N. Y. Supp. 637 (Sup. Ct. 1934); *In re* Lawyer's M't'g Co., 169 Misc. 802, 825, 9 N. Y. S. (2d) 127, 149 (Sup. Ct. 1938). Even closer adherence to the *Boyd* rule will follow Case v. Los Angeles Lumber Products Co., 60 Sup. Ct. 1 (U. S. 1939), which tightened up recent relaxations in its application manifested in Downtown Investment Ass'n v. Boston Metrop. Bldgs., Inc., 81 F. (2d) 314, 323, 324 (C. C. A. 1st, 1936), and in *In re* A. C. Hotel Co., 93 F. (2d) 841 (C. C. A. 7th, 1937).

19. For a discussion of the status of a parent in the reorganization of its subsidiary, see Rembar, *Claims Against Affiliated Companies in Reorganization* (1939) 39 COL. L. REV. 907, 914, *et seq.*

that confirmation of the plan as it affected the guarantee, in the federal proceeding under Chapter XI, would influence the decision in the state court on grounds of comity,[20] so that parallel modification of Trinity's obligation could be achieved without disturbing Realty's equity.[21] Thus, the strategy of Realty placed it in a position to obviate effects of the *Boyd* doctrine entirely.[22]

Furthermore, grave danger of unfairness in a plan allowed under the debtor's attempted use of Chapter XI lay in the doubt surrounding the status of "creditors not affected by the plan."[23] In dealing solely with the claims of certificate holders, the plan failed to accord equal treatment to all groups of unsecured creditors. Under Section 57(h) of the Act, "secured" creditors whose security is insufficient to cover their claims may prove claims as unsecured creditors to the extent of the debt not protected by collateral. Chief among Realty's "secured" obligations outstanding were its own debentures and its guarantee of those of a defunct subsidiary, the George A. Fuller Company.[24] In a Section 77B reorganization of the latter company, Realty had offered to exchange its own debentures on an even basis with those of the George A. Fuller Company, and, pending completion of the exchange, to guarantee the latter's outstanding debentures. At the same time provision was made for a pledge of collateral for both obligations, consisting of voting trust certificates for the common shares of the successor corporation. The pledge was subject to defeasance by occurrence of a condition subsequent, failure of the successor corporation to show certain minimum earnings. Moreover, on the debtor's own admission, the pledged stock had purely nominal value. Accordingly, holders of Realty and George A. Fuller debentures were probably in a position to prove claims as unsecured creditors almost up to the face value of their certificates. Failure of the debtor to effect a modification of these unsecured claims along with its unsecured obligation on the guarantee of Trinity's bonds could result in discrimination against the bondholders through creation of a preference in favor of the debenture holders.[25]

20. Counsel for Realty admitted such was the purpose of its program. Record on Appeal, pp. 276, 277.

21. Although Realty owned over 95% of Trinity's unsecured debt, in addition to its entire capital stock, forced sale of the subsidiary's mortgaged property would undoubtedly have wiped out this equity completely.

22. Had Realty's reorganization plan under Chapter XI entailed formation of a new company, chances of judicial adherence to the *Boyd* doctrine would have been increased. But doubt seems to exist whether or not such a plan could be effected under Chapter XI. See Mulder and Solomon, *Effect of the Chandler Act upon General Assignments and Compositions* (1939) 87 U. of Pa. L. Rev. 763, 790, n. 170. *Cf.* Heuston, *Corporate Reorganizations under Chapter XI* (1938) 38 Col. L. Rev. 1199, 1238.

23. See §§ 107 and 308.

24. $1,135,500 face amount of Realty's own 6% debentures, due January 1, 1944, were outstanding; $1,203,500 face amount of George A. Fuller Company 6% debentures, likewise due January 1, 1944, were outstanding. Record on Appeal, p. 375.

25. But see § 351, which permits the court to divide unsecured creditors into classes, according to their nature and the exigencies of the particular case. Weinstein, The Bankruptcy Law of 1938 (1938) 276. This section gives promise of producing much

Further, it was improbable that any plan confirmed under the Chapter XI proceeding would have been practicable.[26] The situation demanded the more thorough-going shake-up of secured debts and stock interests, as well as unsecured claims, that only Chapter X proceedings can achieve. During eight years of depression, Realty's assets had suffered a phenomenal shrinkage.[27] After default by Trinity, the debtor's liabilities exceeded assets by a substantial figure.[28] Recurring losses had been suffered over a considerable span of time, and prospects of immediate improvement were poor.[29] Under such conditions, the adjustment sought could not prove to be more than, in the words of the dissenting opinion, "a temporary palliative for an incurable financial disease." The debtor would emerge from the courts still fundamentally a corporate cripple, with little or no assurance that it would not be back in court again in the near future. Moreover, the practical necessities of the situation, involving as it did the complexities of a parent-subsidiary relationship, brought it within the domain of Chapter X, under which the whole enterprise could be conveniently and thoroughly dealt with in a single proceeding.[30] No such possibility presents itself under Chapter XI, because provision is not made therein for dealing with subsidiaries, or for altering claims of secured creditors or stockholders.

In light of these substantive considerations, had the debtor filed under Chapter X and made the necessary allegation that adequate relief[31] was not available under Chapter XI,[32] the court would probably have felt compelled to make an affirmative finding that relief under Chapter XI was not adequate. Yet, in Chapter XI, even though identical substantive considerations obtain, such an affirmative finding may not be made, because the chapter contains no provision for a preliminary hearing on the propriety of the proceeding. Hence, paradoxically, a petition proper on its facts under Chapter X for the reason, among others, that adequate relief is not available under Chapter

controversy in the future, a fact of which the parties in the instant case were well aware. Record on Appeal, pp. 301, 302.

Prior to passage of the Act, it was held in *J. P. Morgan & Co. v. Missouri P. R. R.*, 85 F. (2d) 351 (C. C. A. 8th, 1936), that classification of creditors should "in nowise depend upon the nature of the claimant or his interest in the sense of his bias or leanings, but only upon the nature of his claim."

26. Section 366 requires that a plan, to be confirmed, must be "fair and equitable and feasible."

27. In 1930, assets of the debtor totaled approximately $123,000,000; in 1938, $23,478,974. Record on Appeal, p. 55. Revision by the debtor in June, 1939, to reflect market values and estimated values, reduced assets further to $7,076,515. *Id.* at 226, 375.

28. Before default, liabilities totaled $5,551,416; after default, the figure jumped to $9,363,954, as against assets of $7,076,515.

29. Two series of publicly held debentures aggregating $2,339,000 were due January 1, 1944. See note 24 *supra*. On its own admission, Realty's prospects for future earnings were not bright. Record on Appeal, p. 32.

30. §§ 106(13) and 129.

31. "Adequate relief" is a very broad phrase, the meaning of which will have to be supplied by judicial decision. Moreover, "adequacy of relief" may relate to the debtor, creditor, stockholder, even to labor, or to all or any combination of them.

32. § 130(7).

XI might nevertheless be filed under Chapter XI and remain unquestioned on the issue of adequacy of relief until the hearing on confirmation of the plan.[33]

The facts of the instant case would, under Section 77B, have justified dismissal of the petition on the ground that such a petition was not filed in "good faith." That term was used in administration of Section 77B, and has now been accepted in Chapter X, to support broad judicial discretion in refusing petitions where, as here, the prospects of achieving a fair and reasonably thorough reorganization were slim. Preliminary inspection of the financial problem presented by the petition often was followed by dismissals where no reasonable chance of obtaining adequate relief under Section 77B was apparent.[34] But Chapter XI, like Section 75,[35] and unlike Section 77 and Chapters IX, X and XII, contains no provision requiring petitions to be filed in "good faith." Recently, the Supreme Court, in *John Hancock Mutual Life Insurance Company v. Bartels*,[36] gave the provision for "good faith" in the proposal of a plan under Section 75 a more limited meaning than that attached to the comparable language in Section 77B. Reversing the lower court's dismissal of the farmer-debtor's petition, the court held that neither the terms nor the purpose of Section 75 warranted any imputation of lack of "good faith" to a farmer-debtor because of the absence of a reasonable probability of his financial rehabilitation. However, since the philosophy of Section 75 seems to be one of delay for the benefit of a favored class of debtors, while that of Chapter XI is one of speedy reorganization, it is unlikely that the standard of "good faith" under Chapter XI will be so advantageous to debtors as that indicated in the *Bartels* case. But in view of the omission in Chapter XI of express requirement that petitions be filed in "good faith," it is likewise improbable that the more exacting standards of "good faith" applied under Section 77B will be followed under Chapter XI. Instead, courts will, in all likelihood, seek some middle ground.

Aside from the possibility of an implied requirement of "good faith" in filing a petition under Chapter XI, Realty's compliance with the technical requirements of the chapter was impeccable. The debtor was a "person" who could become a bankrupt within the meaning of Section 4;[37] proper allegations of insolvency were made, and a plan offered affecting only an unsecured obligation. Within the literal terms of the Act, its petition was

33. § 366.

34. Tennessee Pub. Co. v. American Nat. Bank, 299 U. S. 18 (1936); Manati Sugar Co. v. Mock, 75 F. (2d) 284 (C. C. A. 2d, 1935). See also Gerdes, *"Good Faith" in the Initiation of Proceedings under Section 77B of the Bankruptcy Act* (1935) 23 Geo. L. J. 418.

35. 49 Stat. 943, 11 U. S. C. § 203 (1935).

36. 60 Sup. Ct. 221 (U. S. 1939).

37. Section 4(a) permits any "person" to become a voluntary bankrupt "except a municipal, railroad, insurance or banking corporation, or a building and loan association." Section 306(3) makes Chapter XI available to any person who could become a bankrupt under § 4. In so far as it appears from the record, Realty had committed no acts barring its discharge as a bankrupt under § 14, such as would prevent confirmation of an arrangement under § 366(4). See *In re* McKesson & Robbins, Inc., No. 72697 (S. D. N. Y. 1939), discussed in note 14 *supra*.

therefore not subject to dismissal before the hearing on confirmation of the plan. Possibly a clear showing that the court had abused its discretion by holding action on the confirmation in abeyance and wrongfully refusing to dismiss the petition would have moved a court of review to find error on appeal from the order of denial. However, no such treatment of the SEC's motion to dismiss Realty's petition could be inferred from the action of the district court in endeavoring to effect a compromise among the parties and, for that purpose, withholding judgment on the plan until amendments thereto should have proved patently useless.[38]

Even the provisions of the Act governing intervention by the SEC operated in favor of the debtor. While Section 208 of the Act expressly authorizes intervention by the Commission in a Chapter X proceeding upon request of the judge or upon its own motion, if approved by the judge, it forbids the Commission to appeal from any order entered in such a proceeding.[39] And Chapter XI is completely devoid of permission for the SEC to intervene. Nevertheless, there is no compulsion toward the position of the court that the SEC had neither a right to intervene, even for the limited purpose of contesting "jurisdiction," nor a right to appeal from an adverse ruling thereon. The Commission relied, not on the terms of the Act, but upon Rule 24(a)(2) of the Federal Rules of Civil Procedure, in conjunction with the broad purpose underlying the Act.[40] The Rule creates a right of intervention, extraneous to provisions of the statute,. where "the representation of the applicant's interest by existing parties is or may be inadequate and the applicant is or may be bound[41] by a judgment in the action."[42] The

38. The proceeding barely escaped dismissal in the district court after the hearing on confirmation of the plan, but was held open pending amendment of the plan by the debtor, subject to the condition of immediate payment of 1½% interest as a sop to dissatisfied certificate holders. Record on Appeal, pp. 359, 360. Only the overwhelming number of certificate holders opposed to dismissal made this compromise possible. *Id.* at 352 *et seq.* Chief objection voiced against use of Chapter X was its undue expense and delay. *Id.* at pp. 353, 355, 358. However, even the heartiest exponents of Chapter XI seemed troubled by the absence of provision therein for separate bond-holders' committees. *Id.* at pp. 183, 214, 252.

39. See MOORE'S BANKRUPTCY MANUAL (1939) 561, 562.

40. Grounds upon which the district court made its order allowing intervention by the Commission were at first ill-defined, but subsequently the court expressly based the order upon Federal Rule 24(a)(2). Record on Appeal, p. 336. The Federal Rules of Civil Procedure are applicable to proceedings in bankruptcy. Federal Rule 81(a)(1) and General Orders in Bankruptcy XXXVII and XLVIII. Rule 24(a)(2) constitutes, in general, a mere application and restatement of the earlier equity practice. See 2 MOORE, FEDERAL PRACTICE (1938) 2325. However, one substantial change effected by the rule has been to abolish the old doctrine of Equity Rule 37 that intervention must be in subordination to, and in recognition of, the propriety of the main proceeding. *Id.* at 2326. If the intervenor's right of intervention is absolute, his attack on the propriety of the proceeding may not be met by the subordination rule in any event. *Id.* at 2379 *et seq.*

41. The concept of being "bound" by a judgment, in this connection, has been held to include "probable prejudice" to the applicant as a result of the judgment. Percy Summer Club v. Astle, 110 Fed. 486, 488 (C. C. N. H. 1901).

42. The right of intervention created by Rule 24(a)(2) is to be liberally construed. Rules 1 and 61 so indicate. Moreover, there has been judicial recognition that such is the

function of the SEC, in accordance with the legislative premise on which the Act is based, is to protect the widely scattered and disorganized investing public through impartial supervision of reorganizations in which the public has a stake.[43] Therefore, it can be argued that, in so far as initiation of a Chapter XI preceeding by a debtor with security issues widely held by the public, as in the instant case, threatens to impair performance by the SEC of its statutory duties, the Commission has an interest in the litigation sufficient to allow its intervention.[44] Sufficiency of the SEC's interest in the proceeding finds substantiation in cases in which state bank commissioners have been permitted to intervene in federal receiverships for protection of their duties under statute to take possession of and administer the assets of insolvent banks.[45] While custodianship differs from the bare right of supervision contended for by the SEC, the distinction lies only in the extent and incidents of supervisory control, not in its nature. Both the SEC and the state bank commissioners had as their primary interest the fair and equitable disposition of the assets of insolvents.

Moreover, intervention for the limited purpose of attacking "jurisdiction" must be distinguished from the right to intervene and dispute questions arising in the course of proceedings once they are properly under way.[46] The

case. United States v. C. M. Lane Lifeboat Co., 25 F. Supp. 410 (E. D. N. Y. 1938). See also 2 MOORE, FEDERAL PRACTICE (1938) 2365.

43. See the statement of William O. Douglas, as Commissioner of the SEC, in *Hearings before the Committee of the Judiciary on H. R. 8040*, 75th Cong., 1st Sess. (1937) 162 *et seq.* As indicated therein, the SEC was itself the author of many provisions reflecting this premise. See also Montgomery, *Defects in Chapter XI of the Bankruptcy Act and Suggested Amendments* (1939) 25 VA. L. REV. 881, 882; Clark, *The Securities and Exchange Commission and the Chandler Act* (1939) 73 U. S. L. REV. 147.

44. While the so-called broad view of intervention, where the Federal Government was concerned in the outcome of litigation, found early expression in The Exchange, 7 Cranch. 116 (U. S. 1812), courts have nevertheless generally allowed government intervention on the basis of some pecuniary or proprietory interest in the proceeding. Norman v. Consolidated Edison Co., 89 F. (2d) 619 (C. C. A. 2d, 1937); Davis v. Boston & M. R. R., 89 F. (2d) 368 (C. C. A. 1st, 1937). Sometimes the facts have not too clearly supported allegations of such interest; yet intervention has been allowed. Florida v. Georgia, 17 How. 478 (U. S. 1854) (boundary dispute between two states); New York v. New Jersey, 256 U. S. 296 (1921) (suit to enjoin pollution of harbor). Presence of a general public interest tends to blur the requirements. Often the proprietary interest relied upon has been formal, amounting in fact to a general public interest. See Percy Summer Club v. Astle, 110 Fed. 486 (C. C. N. H. 1901); Winola Lake and Land Co. v. Gorham, 17 F. Supp. 75 (M. D. Pa. 1936). Many cases seemingly contra are readily distinguishable on the ground that the public interest is adequately represented without intervention. See New York City v. New York Tel. Co., 261 U. S. 312 (1923); Chicago v. Chicago Rapid Transit Co., 284 U. S. 577 (1931).

45. Pennsylvania v. Williams, 294 U. S. 176 (1935); Gordon v. Ominsky, 294 U. S. 186 (1935). Intervention in these cases was not contested, but the allowance of intervention indicates that the interest of the state bank commissioners was deemed sufficient. The distinction sometimes made between the sovereign and an agency of the sovereign for other purposes apparently did not affect the right of intervention here. See also Hopkins v. Cleary, 296 U. S. 315, 337 *et seq.* (1935).

46. Opportunity to make preliminary attacks upon the propriety of the proceeding does not entail the possible dilatory effect of complete intervention. Hence, fear that ex-

latter power was not sought by the SEC. But the former is a prime requisite for the Commission, if it is expected to preserve the elaborate safeguards of Chapter X from the emasculatory effects of improper resorts to Chapter XI.[47]

Were it admitted that denial of an absolute right to intervene was correct, there is still no reason why the order of intervention could not have been sustained as a proper exercise of judicial discretion, pursuant to Federal Rule 24(b)(2).[48] And, once intervention has been granted, whether permissive or absolute, the intervenor has the right to appeal from all interlocutory or final orders which affect him, and from which an appeal is provided by statute.[49] When intervention is accorded the SEC under the Federal Rules, not under the Act, the Commission's status is that of an ordinary party in the proceedings; and the basis of its appeal is the same as that of such a party.[50] Therefore, absence of provision for appeal by the SEC in Chapter X, being for this purpose solely evidence of the policy behind the Act, goes to the discretion of the lower court in allowing the appeal, rather than to its powers, or to the appellate jurisdiction of the court of review. Allowance of the appeal, in a case involving highly important questions of statutory construction, seems to have been a reasonable exercise of discretion. Such reasoning would have buttressed the court's determination of the "jurisdictional" issue against possible later attack on grounds that, since the issue was never properly raised and was therefore unnecessarily decided, disposition thereof constituted dictum.

Even though open to such attack, the court's disposition of the case represents a sensible and practical course of judicial action. Two omissions in Chapter XI compelled the court to uphold the propriety of the Chapter XI proceeding. No provision can be found in Chapter XI for a preliminary hearing on the propriety of the proceeding; nor is there any clause making want of "good faith," whether in the form of prospective inadequacy of relief or some other form, grounds for immediate dismissal. Thus there was no express statutory basis, in the early stages of the proceeding, for arguing that a corporation with securities widely held by the public was not suited to a proceeding under Chapter XI.

The omission of a preliminary hearing could be supplied by amendment without unreasonably impairing expediency of the chapter. But even with

peditiousness of the proceeding might suffer, which is the principal reason for forbidding complete intervention, offers less compulsion toward denial of limited intervention.

47. Inertia of the investing public being a recognized consideration in SEC supervision of reorganizations, it seems inconsistent to call off the statutory watch-dog in the belief that the investor can be expected to take the initiative in protecting his own interests.

48. In his dissenting opinion, Judge Clark, himself an author of the Federal Rules, pointed out the applicability of Rule 24(b)(2), which provides for permissive intervention when the petitioner has an interest in a question of law or fact common to the pending litigation. This discretionary right has been described as a "matter of trial convenience." 2 MOORE, FEDERAL PRACTICE (1938) 2332. Hence, if used as a device to make possible the interpretation of an important statute, Rule 24(b)(2) would seem to be within the scope of its intended function.

49. See 2 MOORE, FEDERAL PRACTICE (1938) 2371.

50. See note 12 *supra*.

the Act in its present form, a possible solution of the difficulty is implicit in the general equity powers of the court.[51] Some basis for a creditor's motion to dismiss for want of "good faith" may be derived by implication from Section 312 of the Act, which renders jurisdiction of a Chapter XI court comparable to that of a bankruptcy court on adjudication. It is a well-recognized informal practice in bankruptcy to permit creditors to raise the question of jurisdiction and to appeal from an adverse ruling thereon, even in cases where they do not have full standing as parties before the court.[52] And if the SEC is accorded the status of a party for the sole purpose of contesting "jurisdiction," it seemingly should enjoy rights commensurate with those of creditors for that limited purpose. A further suggestion, having the advantage of effecting a transfer of proceedings from Chapter XI to Chapter X instead of merely a dismissal of the Chapter XI proceeding, would be to consider filing of the petition under Chapter XI as an act of bankruptcy and on the basis thereof permit creditors to file an involuntary petition under Chapter X.[53] To reach either of these results an inference must be unearthed from Chapter XI that prospective inadequacy of relief thereunder renders the proceedings subject to dismissal. While the provision in Chapter XI making it a prerequisite to confirmation of the plan that the proposal and its acceptance be "in good faith" enjoys sufficient elasticity to support an argument to this effect, absence in Chapter XI of the provision for a preliminary hearing present in Chapter X indicates a contrary legislative intent.

The mechanical defects discussed bid fair to cause a breakdown in the accomplishment of the purposes commonly supposed to underlie the two chapters.[54] Speedy, but well-considered, legislative amendment appears to

51. Judge Clark pointed this out in his dissent. See also Rostow and Cutler, *supra* note 3, at 1366, 1367.

52. General creditors have no such standing in a voluntary proceeding in bankruptcy as to allow them to file an answer or move to vacate an adjudication, but this fact has not prevented them from properly raising the question of jurisdiction. Royal Indemnity Co. v. American Bond & Mtg. Co., 61 F. (2d) 875 (C. C. A. 7th, 1932), *aff'd*, 289 U. S. 165 (1933); *In re* Ettinger, 76 F. (2d) 741 (C. C. A. 2d, 1935); Chicago Bank of Commerce v. Carter, 61 F. (2d) 986 (C. C. A. 8th, 1932); Vassar Foundry Co. v. Whiting Corp., 2 F. (2d) 240 (C. C. A. 6th, 1924); Blackstock v. Blackstock, 265 Fed. 249 (C. C. A. 8th, 1920); *In re* Guanacevi Tunnel Co., 201 Fed. 316 (C. C. A. 2d, 1912); *In re* Nash, 249 Fed. 375 (S. D. W. Va. 1918).

53. Such reasoning has a difficult hurdle to jump when it becomes necessary to find that the Chapter X petition supersedes the prior petition under Chapter XI, thus ousting the Chapter XI court from jurisdiction. For analysis of these difficulties and a solution thereof, see Rostow and Cutler, *supra* note 3, at 1368 *et seq.*

54. Not only may many corporations in a position similar to that of Realty employ the same tactics; but others could immunize their equities in properties against possible future divestment under a Chapter X proceeding by setting up subsidiaries and conveying the properties to them. But, in the instant case, although the manner of effectuating the plan was devious, it is not certain that it was unfair. Ulterior motives cannot justly be ascribed to the institutional holders contributing most of the consents. Pursuant to the New York Mortgage Moratorium Act, a deficiency judgment under foreclosure of Trinity's mortgaged property would have been limited to the difference between the mortgage bond debt and the "fair value" of the property by judicial appraisal. N. Y. CIV. PRAC. ACT §§ 1077(a), 1083. Certificate holders feared, and the debtor believed, that such a

be the only practical solution. While out of court arrangements and reorganizations, on threat of prolonged and expensive litigation upon refusal to accept the terms offered,[55] and increased use of state machinery,[56] as exemplified by the instant case, are possible loopholes in the Act, the broadest avenue of escape from the regulatory provisions in Chapter X consists of improper resort to Chapter XI. Hence, clarification of the interrelation between the two chapters is prerequisite to effective administration of the Act. Unless the "jurisdictional" disputes now prevalent can be avoided, the avowed mission of Chapter XI to provide expeditious tools for settling small problems of reorganization will meet with failure.[57] And if the protective functions of Chapter X can be conveniently thwarted by abuse of Chapter XI, one of the most comprehensive corporate reforms ever effected may prove to have been a delusive dream.

APPROPRIATE HOLDING PERIOD FOR CAPITAL GAINS TAX AS DETERMINED ON AVERAGE COST BASIS*

THE requirement of the Federal Income Tax Act that the entire gain or loss realized upon the sale of securities be reported in a single year[1] works a grave injustice to either taxpayer or Government in those instances where the gain or loss has accrued gradually over a period of years. To compensate partially for this inequity, Congress has granted special dispensation to those

deficiency would be inconsequential in amount. Record on Appeal, pp. 164, 353. Since, if this expectation materialized, the debtor would be free of its obligation on the guarantee, and since remedies as to principal must first be exhausted against the primary obligor, the debtor was justified in claiming that its p'an offered something to the certificate holders that they did not already have, a continuing investment. However, the question whether or not the plan was a fair compromise cannot be answered with any definiteness.

55. Complete suppression of such tactics must probably await revision of the incorporation laws on a national scale. The competitive psychology which drives state incorporation laws into deeper and deeper morasses of ineffectiveness gives little promise of bringing about improvement in out of court reorganization standards. See Bresnahan, *Will Provisions of the Chandler Bill Extending SEC Powers Afford Adequate Protection to Corporate Investors?* (1938) A 1 CORP. REORG. 342. Suggested methods of introducing Federal Incorporation to cover reorganization problems find expression in Teton, *Reorganization Revised* (1939) 48 YALE L. J. 573, 607 *et seq.*; Levi, *Corporate Reorganization and a Ministry of Justice* (1938) 23 MINN. L. REV. 1, 20.

56. Advantages of state proceedings in evading the much less strict § 77B proceedings were beginning to be appreciated before the advent of Chapter X. See Comment (1938) 36 MICH. L. REV. 434.

57. However, in the "reorganization" or "arrangement" of real estate properties, as in the instant case, dilatory proceedings do not spell disaster, as they might in the case of manufacturing concerns. See *Hearings before Committee on the Judiciary on S. So46,* 75th Cong., 1st Sess. (1938) 85.

* William E. Mitchell, 40 B. T. A. 424 (1939).

1. INT. REV. CODE § 41 (1939).

whose securities have been held for a long term. Thus in the earlier revenue acts,[2] Congress taxed long term security gains at a flat 12½% rate, while levying upon short term gains as ordinary income. In later acts[3] this same objective has been accomplished by treating as income varying proportions of the gain realized, dependent upon the length of time the security has been held. Thus, before computing taxable gain or deductible loss realized from the sale of securities, it is imperative to determine the cost basis of the security sold and the period for which it was held. Yet Congress, although attaching great importance to the holding period,[4] has not indicated an appropriate method to determine which particular securities among the total holdings of the same class are to be treated as sold. Instead the task has been delegated to the Treasury Department.[5] The resulting Treasury regulations have permitted the taxpayer to identify[6] or otherwise to designate[7]

2. *E.g.*, Revenue Act of 1921, § 206; Revenue Act of 1932, § 101.

3. Revenue Act of 1934, § 117; Revenue Act of 1936, § 117; Int. Rev. Code, § 117 (1939). Under the Revenue Act of 1939, § 117, three holding periods are recognized. Gain or loss from securities held less than 18 months is taxable or deductible on the total amount of gain or loss realized, but "short term loss shall be allowed only to the extent of short term capital gain." Corresponding gain or loss from securities held more than 18 months but less than 24 and from securities held more than 24 months is taxable or deductible on the basis of 66⅔% and 50% respectively, but in no case can such tax on net long term capital gain exceed 30% of the amount of taxable gain. In the case of net short term capital loss a partial tax is first computed upon net income increased by the amount of the net long term capital loss, at the rate applicable to ordinary income, and the total tax shall be the partial tax minus 30% of the net long term capital loss.

4. The term "holding period" is used throughout this Note in order to eliminate recurring reference to specific acts. However, it must be realized that the earlier acts recognized no such "holding periods" as do the recent ones. According to the earlier acts, security transactions resulted in capital gain or ordinary income depending on whether they had been held more than, or less than, two years. Recent acts have, on the other hand, taxed all gains and losses on securities as ordinary income but have compensated for long term holdings by recognizing several holding periods. Under the 1938 Revenue Act where three such periods are defined, long term gains are taxable at a rate not to exceed 30% of the total taxable gain realized. Actually then, long term gain is at present taxed not more than a flat 15% of the total gain realized. It therefore appears that the present capital gains tax is very similar to the original flat 12½% rate, and it seems that no reason remains to attempt to distinguish the two types of acts.

5. Int. Rev. Code § 62 (1939).

6. It has been said that the Treasury regulations [*infra* note 8] create a presumption that shares of stock sold from an unidentifiable lot were the first acquired and that the burden rests upon the taxpayer to show the identity of the stock sold. Where the shares sold are capable of being identified by certificate number as having been purchased at a certain time and at a certain price, the courts have ruled that the shares represented by certificate delivered are to be considered as the shares sold. Foley v. Comm'r, 94 F. (2d) 958 (C. C. A. 3d, 1938). See also Helvering v. Rankin, 295 U. S. 123 (1935).

7. Even where the shares are not identifiable by certificate, if the shareholder manifests to his broker an unambiguous intention to sell shares purchased at a certain price and on a certain date, the shares so designated will be considered to be the ones sold. Vawter v. Comm'r, 83 F. (2d) 11 (C. C. A. 10th, 1936). But a request to one's broker to sell shares costing the most is ineffective as a designation when the proper certificates

specific securities to be sold. Frequently, however, the taxpayer, by failing to keep proper records or by neglecting at the appropriate time to identify or designate, loses his privilege of self-selection. When the taxpayer is thus disabled, the Treasury regulations establish a presumption that the taxpayer has sold those shares first acquired — the "first-in, first-out" rule.[8] But where shares are commingled in corporate reorganization,[9] the inconvenience[10] of applying the identification and "first-in, first-out" rules has prompted a notable exception:[11] shares received in reorganization must be averaged over the total cost of the old shares exchanged in determining the cost basis of the new shares sold after the reorganization.[12] Although this exception solves the problem of the calculation of the cost basis, it leaves unsettled the selection of the applicable holding period. The perplexity of the Treasury Department and the taxpayer, when confronted with the problem of applying the proper holding period to hopelessly commingled shares, is graphically illustrated by a recent case before the Board of Tax Appeals.[13]

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were not delivered. Davidson v. Comm'r, 94 F. (2d) 303 (C. C. A. 8th, 1938), *aff'd*, 305 U. S. 44 (1938); (1938) 38 Col. L. Rev. 932; (1939) 37 Mich. L. Rev. 503. Intent alone will not suffice but must be accompanied by some unequivocal manifestation. Horner v. Comm'r, 72 F. (2d) 407 (C. C. A. 3d, 1934).

8. U. S. Treas. Reg. 101, Art. 22(a)8: "If shares of stock in a corporation are sold from lots purchased at different dates or at different prices and the identity of the lots cannot be determined, the stock sold shall be charged against the earliest purchaser of such stock." This regulation with but minor changes in wording has existed since 1917. U. S. Treas. Reg. 33, Art. 4, ¶ 60.

9. Although the cases in which the identity of shares has been held to be lost upon reorganization deal almost exclusively with statutory tax-free reorganizations, there appears no reason for so limiting this rule. Recently the rule has been extended to a sale of corporate assets. Wesley Terhune, 40 B. T. A. 749 (1939). The rule is realistically reasoned upon the fact that shares when exchanged in reorganization go into a "hodgepodge" during which time even the transfer agent is unable to determine the identity of the respective shares, and that when the new shares are issued, they are exchanged not for a certain certificate evidencing a certain number of old shares, but rather for the individual's shareholdings in general.

10. Upon reorganization the taxpayer's total shareholdings are simultaneously exchanged for new shares. Consequently, these new shares are not acquired "at different times and at different prices" but at the same time and for identical consideration, and therefore, the "first-in, first-out" rule does not appear applicable to shares acquired in reorganization. Raoul Fleischmann, 40 B. T. A. 671 (1939) (discussing cases cited *infra* note 11).

11. Comm'r v. Bolender, 82 F. (2d) 591 (C. C. A. 7th, 1936); Comm'r v. Oliver, 78 F. (2d) 561 (C. C. A. 3d, 1935); Comm'r v. Von Gunten, 76 F. (2d) 670 (C. C. A. 6th, 1935). Helvering v. Stifel, 75 F. (2d) 583 (C. C. A. 4th, 1935); Henry Hudson, 39 B. T. A. 1075 (1939); Harry Runkle, 39 B. T. A. 458 (1939).

12. This exception is not found in the Treasury regulations themselves, but rather in court and Board of Tax Appeals opinions. Comm'r v. Bolender, 82 F. (2d) 591 (C. C. A. 7th, 1936); Comm'r v. Von Gunten, 76 F. (2d) 670 (C. C. A. 6th, 1935); Wesley Terhune, 40 B. T. A. 749 (1939); Raoul v. Fleischmann, 40 B. T. A. 671 (1939). How the Treasury Department regards this exception is not clear, inasmuch as the Department's repeated non-acquiescence to the average cost rule of the *Von Gunten* case has just recently been reversed. 1939-I Cum. Bull. 36; non-acquiescence XII-2 Cum. Bull. 27 (1933) withdrawn. See also U. S. Treas. Reg. 101, Art. 113(a)(12)-1.

13. William E. Mitchell, 40 B. T. A. 424 (1939).

There the taxpayer in 1924, pursuant to a reorganization, exchanged his shares of one corporation for those of a second. Subsequently these holdings were increased by stock dividends and purchases of additional shares of the second corporation. In 1929, pursuant to a second reorganization, the taxpayer exchanged his total holdings in the second corporation for shares and warrants of a third corporation. During the years 1929 and 1930, numerous shares of both the second and third corporations were sold by the taxpayer in many separate lots, all at a gain. In determining the amount of taxable gain realized, the taxpayer who alleged ignorance of the "first-in, first-out" rule, attempted to match each share sold with a particular purchase, choosing always the highest-priced shares. The Commissioner of Internal Revenue, on the other hand, applied the "first-in, first-out" rule to all but the few shares properly identified, and concluded that the taxpayer's income, as reported in 1929 and 1930, was greatly understated. The Board of Tax Appeals approved the Commissioner's application of the "first-in, first-out" rule to the shares sold prior to the second reorganization,[14] but with respect to the shares sold thereafter, held that by applying the "first-in, first-out" rule and by failing to utilize the rule of averaging which is appropriate when there is a reorganization, the Commissioner had overstated the taxpayer's taxable gain.[15]

The holding of the Board that the taxpayer erred in attempting to match hopelessly unidentifiable shares with particular purchases was completely in line with authority.[16] An unambiguous designation[17] to sell certain shares, communicated to one's broker, absent a reorganization, is the only means whereby unidentifiable shares may escape the application of the "first-in, first-out" rule. Orthodox also was the Board's repudiation of the "first-in, first-out" rule for sales of shares acquired after the second reorganization, and its use instead of the average cost rule.[18] But the Board failed to state[19] whether the gain so realized was taxable as long or short term, depending, under the applicable revenue act,[20] on whether the shares had been held more than, or less than, two years. Certainly the Board did not mean to run the holding period from the date on which the shares were exchanged, inasmuch

14. *Id.* at 450.

15. *Id.* at 451.

16. As to shares sold before reorganization: Snyder v. Comm'r, 295 U. S. 134 (1934); Horner v. Comm'r, 72 F. (2d) 407 (C. C. A. 3d, 1934). As to shares sold after reorganization; Comm'r v. Bolender, 82 F. (2d) 591 (C. C. A. 7th, 1936); Comm'r v. Von Gunten, 76 F. (2d) 670 (C. C. A. 6th, 1935).

17. The present rule seems to be most concisely expressed by Member Murdock, dissenting in Uzal H. McCarter, 34 B. T. A. 535, 540 (1936): ". . . where there is no designation and no other means of identification, the Commissioner applies the first in, first out rule; in cases where there is identification by certificates, he uses that means of identification; and, finally, in cases where there is identification by designation of shares otherwise not identifiable, then that method of identification must be used."

18. See note 11 *supra*.

19. It is difficult to determine from the Board's opinion just why the holding period was not computed. Perhaps determination of the holding period was either unimportant or had been previously stipulated by the parties.

20. REVENUE ACT OF 1928, § 101.

as the "relation-back" rule in the statute unequivocally stated that "in determining the period for which the taxpayer has held stock or securities received upon a distribution . . ., there shall be included the period for which he held the stock or securities in the distributing corporation prior to the receipt of the stock or securities upon such distribution."[21] Since the shares exchanged had been held by the taxpayer for periods varying from a few weeks to many years, under the "relation-back" rule the new shares constituted both long and short term holdings. Yet neither judicial opinion, Board of Tax Appeals decisions, Treasury Regulations, nor General Counsel's Memoranda suggest a way to adapt the holding period principle to shares hopelessly merged through reorganization.[22]

The riddle left unanswered by the Board has several possible solutions. Symmetrical with the use of the average cost basis would be the use of an average holding period.[23] If the resultant average was more than two years, then the total gain would be treated as long term even though some shares had been held for only a few weeks. Use of the average holding period method is, however, unwarranted. By recognizing but one holding period, such a method not only seems to contradict the express design of the applicable statute, which provides for two periods,[24] but is subject to possible tax evasion. In those instances where a greater deduction is desired by the taxpayer, who intends to liquidate long term security holdings, the increased deduction could be obtained by purchasing additional shares sufficient to raise the average holding period of the securities sold from long to short term. The average holding period method is further unwarranted, since in computing the average, the time multiple applied to those securities held for a long term is disproportionately greater than that applied to those held for a short period. Hence the tendency of the average holding period method would be to make capital gains predominately long term.[25]

As a second possible method of determining the holding period, the Board might have applied to the average cost basis a "first-in, first-out" rule. Thus

21. REVENUE ACT OF 1928, § 101 (c) (8) (C). The corresponding section of the present Revenue Act likewise runs the holding period from the date of acquiring the original stock. INT. REV. CODE § 117(h) (2) (1939).

22. Only recently has the holding period problem under the average cost basis rule been recognized. MONTGOMERY, FEDERAL INCOME TAX HANDBOOK (1938) 135. In addition, the Board of Tax Appeals, recognizing the importance of determining the holding period when securities are averaged in reorganization, has recently urged the Treasury Department to provide a solution. Jacob Epstein, 36 B. T. A. 109 (1937).

23. According to the average holding period method, all the new shares sold would be presumed to have been held for a period equivalent to the sum reached by adding to the time elapsed between the reorganization and the sale, the quotient obtained after multiplying the total number of shares in each lot by the days, months and years which said shares were held (that is, up to the time of the reorganization), adding the resulting products and dividing by the total number of old shares.

24. REVENUE ACT OF 1928, § 101.

25. Where the taxpayer holds several lots of the same class of stock, some of these lots will usually have been held considerable lengths of time. Under the average holding period method, 100 shares held for four years has equal weight in the average as 800 shares held for six months.

the shares of new stock first sold would be deemed to have been held for the same length of time that the equivalent number of old shares first purchased would have been held, had there been no reorganization. The flaw in this procedure is, however, apparent. Since the gain or loss realized from each sale is a product of commingled long and short term holdings, it is unreasonable to treat gains from early sales exclusively as long term holdings, and from later sales, as exclusively short term holdings.

Most effective as a solution to the enigma is the adoption of a proportionate holding period. According to this method a percentage of the total gain or loss resulting from securities sold after reorganization is allocated to each holding period — which must of course relate back to the date at which the old shares were acquired — in the proportion that the number of shares held for each period bears to the total shareholdings. An example will clarify this method of calculation. A case might arise where *A* purchased 200 shares of *X* stock in 1934 at $25 per share, 100 shares in April, 1937 at $29 per share and 300 shares in December, 1938 at $35 per share. In January, 1939, pursuant to a reorganization, *A* exchanged his 600 shares of *X* stock for 1200 shares of *Y* stock, the average cost being $15 per *Y* share. Later in January, 1939, he sold 200 shares of *Y* stock at $18 per share, thereby realizing a gain of $3 per share or a total of $600. Of the 1200 shares of *Y* stock, 400 shares (⅓ of the total), 200 shares (⅙ of the total) and 600 shares (½ of the total) must under the statute "relate-back" to the dates of acquisition of the 200, 100 and 300 shares of *X* stock, respectively. According to the Revenue Act of 1939, *A*'s total holdings were thus composed of shares which fall into each of the three holding periods. In determining the gain on the 200 shares sold, ⅓, ⅙, ½ of the gain would be apportioned to each respective holding period and taxed accordingly.[26] By contrast to the average and "first-in, first-out" holding period methods, the proportionate holding period rule would seem to furnish the fairest and most symmetrical result for both Government and taxpayer, inasmuch as it recognizes that the gain or loss has been computed from the average of many shares held varying lengths of times, and accordingly, distributes that gain or loss, not to an arbitrary "first-in, first-out" period, but to the varying periods from which the securities were probably sold.

The reasonable result obtained in reorganization cases by employing a proportionate holding period with an average cost basis suggests that this method might well be carried over to all security transactions even where a reorganization is absent and the shares are identifiable. The methods now employed, the identification and "first-in, first-out" rules, are susceptible of severe criticism, both ideological and practical.[27] Realistically, the taxpayer's

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26. The amount of taxable gain would thus be:

⅓	($600 x 50%)	=	$100.00
⅙	($600 x 66⅔%)	=	66.67
½	($600 x 100%)	=	300.00
			$466.67

27. The present rules ignore not only brokerage practices [Millikan v. Comm'r, 83 F. (2d) 213 (C. C. A. 2d, 1936); John Snyder, 20 B. T. A. 778 (1930)], but also the

total interest in a corporation, as evidenced by shares of stock of the same class, might well be viewed as a lump holding. There exists, therefore, no compelling reason for adherence to the present rule permitting identification of particular shares.[28] Practically, application of this rule has resulted in a mad scramble on the part of taxpayers to earmark particular securities and to indicate, as sold, certificates evidencing the highest cost purchases,[29] thus reporting minimum gains and maximum deductible losses. Since the process of identification is so unfavorable to it, the Government, on the other hand, has closely examined the circumstances surrounding each such attempt in an endeavor to show that the certificates so used evidenced unidentifiable shares and that therefore the "first-in, first-out" rule should be applied.[30] The consequence has been a flood of needless litigation.[31] Ironically also, the identification rule favors the wealthy taxpayer who is generally the beneficiary of legal advice and is more often able to assert his privilege of self-selection.

Even an abandonment of the identification rule in favor of the "first-in, first-out" rule would not lead to satisfactory results. Particularly distressing to the Government has been the fact that the "first-in, first-out" rule, which worked so favorably for it in the rising markets of the 'Twenties, now results, and in all probability will continue to result for some time, in a paucity or a reduction of revenues. In the erratic present-day security markets, more often than not the earliest purchased shares will not have been priced below the later purchased ones, and the difference in the cost bases between the earlier and later purchases, when the former actually cost less than the latter, will not be sufficient to compensate for the 50 per cent basis on which long term gains are at present taxable. Continued insistence, therefore, under this rule that the shares first purchased be deemed to be those first sold, combined with the inevitability of fluctuations in the business cycle, will further accentuate the already uneven flow of Governmental receipts.

All these disadvantages of the identification and "first-in, first-out" rules could be obviated by adopting the suggested average cost basis and the proportionate holding period rule. Simple of administration, such a rule realisti-

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actual workings of most marginal accounts. Frequently it is the last margin purchase which embarrasses taxpayer and causes him to sell. Thus it would appear more realistic to govern marginal transactions, which furnish about 50% of the cases in this field, by a last-in, first-out rule. *Cf.* Robert Bingham, 27 B. T. A. 186 (1932) (short sales are subject to a last-in, first-out rule).

28. Although identification of shares by certificate is permitted in order to enhance negotiability [UNIFORM STOCK TRANSFER ACT § 1] and in order to provide a situs for tax jurisdiction [De Ganay v. Lederer, 250 U. S. 376 (1919)], the stock certificate has usually been considered merely evidence of ownership in an undivided interest in the concern as a whole. Richardson v. Shaw, 209 U. S. 365 (1908).

29. On the other hand, a taxpayer with large short term capital losses would probably desire to indicate as sold low cost securities so as to realize short term capital gains against which to offset short term capital losses.

30. See William E. Mitchell, 40 B. T. A. 424, 455 (1939) (concurring opinion) (pointing out the faults in the "first-in, first-out" rule).

31. Since 1934 litigation on these issues has resulted in 3 Supreme Court cases, 23 circuit court cases, 5 district court cases and 41 Board of Tax Appeal cases.

cally regards the sale of a portion of total security holdings not as an isolated incident, but, rather, as the liquidation of a cross-section of a lump holding. By eliminating the taxpayer's opportunity to identify or otherwise to designate high- or low-cost securities as the portion sold from among the many held, and by establishing a more stable cost basis, the suggested rule should result in a greater regularity of Governmental revenues.

As against these advantages of the average cost basis and the proportionate holding period rule, it might be alleged, in order to discourage its application to shares other than those exchanged in reorganization, that such a rule is overly susceptible of tax evasion. Inasmuch as the number of shares to be averaged in the case of ordinarily commingled groups of securities is not limited, as in the reorganization situations, to those procured in reorganization, nothing prevents the purchase for immediate sale of additional shares by the taxpayer.[32] Thus a taxpayer who intends to establish a deductible loss by selling shares all of which represent long term holdings could by purchasing additional shares and immediately selling all shares, both original and newly acquired, raise the proportion of short term holdings, and could thereby report on the same amount of actual loss a greater deduction than had he not bought and immediately sold such additional shares.[33] However, this increased deduction benefits the taxpayer only when it can be offset by short term capital gain. And were this apparent method of tax evasion to become rife, it could easily be remedied by enacting a regulation excluding from the proportionate holding period rule all purchases made within the three months next preceding any sale of the same class of stock.[34]

It would seem therefore, that an attempt should be made to supplant the identification and "first-in, first-out" rules by a formula, applicable to all securities, which contains an average cost basis and a proportionate holding period. But just how to accomplish this end is doubtful,[35] inasmuch as the

32. There is no opportunity for tax evasion in the case where the taxpayer intends to sell long term security holdings for a gain. The taxpayer is not benefited by purchasing additional shares at the market in order to reduce the average gain per share, since such reduction is compensated by the fact that the taxpayer at the same time, by increasing the number of shares with a short term holding period, must thereby report a larger proportion of his gain as current and 100% taxable.

33. In addition, if the taxpayer buys and immediately sells additional shares, equal in number to the amount of his original holdings, he could, while still retaining his original position, report a deductible loss almost equivalent to that which he could have reported had he merely sold his original shares without making the additional purchase.

34. Congress has eliminated a similar type of tax evasion by means of the "wash sale" provisions in the latest revenue act. INT. REV. CODE § 118 (1939).

35. Judicial authority, repudiating the use of the average cost basis under all circumstances, is wholly dicta. See Kraus v. Comm'r, 88 F. (2d) 616, 618 (C. C. A. 2d, 1937); Skinner v. Eaton, 45 F. (2d) 568, 570 (C. C. A. 2d, 1930). See also KLEIN, FEDERAL INCOME TAXATION (1929) 346; (1932) 6 ST. JOHN'S L. REV. 416, 417. Nevertheless, although an average has been used to arrive at a cost basis for stock subscription rights, Miles v. Safe Deposit & Trust Co., 259 U. S. 247 (1922); Ayer v. Blair, 25 F. (2d) 534 (App. D. C. 1928), and for shares acquired in reorganization [see cases cited note 11 *supra*], the courts have been hesitant to extend the averaging rule to such closely analogous situations as stock split-ups. Kraus v. Comm'r, *supra*. This hesitancy

Treasury regulations prescribing the "first-in, first-out" rule not only have repeatedly been held by the courts to be reasonable interpretations of the statute,[36] but by successive reenactments, without substantial change, of sections of the revenue acts pertinent to these regulations, are now deemed to have the force of law.[37] However, the Treasury Department's power to promulgate regulations overruling previous regulations which have the effect of law has recently been upheld.[38] Nor should the prohibition of retroactive application of revised regulations[39] hinder the adoption of the suggested rule. It would appear that the sale, and not the purchase, of securities is the transaction against which the bar of retroactivity is directed, and that therefore the average cost and proportionate holding period could be adopted for all sales consummated after the suggested revision has been promulgated.

FEDERAL TAXATION OF COMBINED ANNUITY AND LIFE INSURANCE CONTRACTS*

THE development of a business institution conceived as a device for tax avoidance is illustrated by the growth of the combination annuity and life insurance policy.[1] According to the terms of a typical policy, the insurance company agrees, in return for a single lump sum payment, to pay an annual amount to the insured for the duration of his life and on his death to pay the amount of the original premium to his named beneficiary.[2] The policy contains the usual provisions for cash surrender value, loans and the change of beneficiaries, but no physical examination is required for its issuance. The

seems to stem not from any fundamental hostility to a rule such as the one suggested, but rather, from a constraint to follow the already existing Treasury regulations prescribing the identification and "first-in, first-out" rules. See Member Murdock, concurring in William E. Mitchell, 40 B. T. A. 424, 455 (1939).

36. Comm'r v. Merchants' & Mfrs'. Fire Ins. Co., 72 F. (2d) 408 (C. C. A. 3d, 1934); Snyder v. Comm'r, 54 F. (2d) 57 (C. C. A. 3d, 1931).

37. Helvering v. Reynolds Tobacco Co., 306 U. S. 110 (1939).

38. Helvering v. Wilshire Oil Co., 60 Sup. Ct. 18 (U. S. 1939).

39. Helvering v. Reynolds Tobacco Co., 306 U. S. 110 (1939).

* Estate of Anna M. Keller, 39 B. T. A. 1047 (1939).

1. For a general discussion of insurance used for tax avoidance, see PAUL, STUDIES IN FEDERAL TAXATION (1937) 25, 41; Bassett, *Transfer of Property Through Trusts or Insurance as Avoiding Federal Estate Tax* (1936) 4 KAN. CITY L. REV. 90; Paul, *Life Insurance and the Federal Estate Tax* (1939) 52 HARV. L. REV. 1037, 1074.

2. If the original premium was $42,000, the death benefit would be $40,000. The variation is caused by the insurance company's deduction of a "loading" charge to cover agents' commissions and other administrative expenses. This deduction is common to all of the policies in the cases considered and will be disregarded in their consideration. See Estate of Anna M. Keller, 39 B. T. A. 1047, 1059 (1939); Bowman v. Tax Comm., 135 Ohio St. 295, 20 N. E. (2d) 916, 917 (1939).

purchaser thus receives what is in effect a life annuity and a paid-up life insurance policy.[3]

Although this division of the combination policy into two features may appear innocent enough to the uninitiated, the federal taxing authorities objected to the dichotomy when such a policy was presented, for purposes of the estate tax, in the *Old Colony* case.[4] There the executors of the insured's estate had claimed that the money received by beneficiaries under the insurance feature came within Section 302(g) of the Revenue Act of 1926, which exempted $40,000 of the insurance proceeds received by beneficiaries of the insured other than his estate.[5] The Commissioner of Internal Revenue argued, however, that the two features of the combination agreement should be construed together,[6] since, by their combination in one contract, the insurance company's risk of loss for one item offset that for the other: if the purchaser died before the expiration of his life expectancy, the company lost on the insurance, but it made a corresponding gain through the termination of the annuity. So construed, he contended, the agreement was not a contract of insurance because the element necessary for insurance — distribution of risk — was absent.[7] He concluded that the proceeds received under it were not insurance proceeds and, therefore, that an exemption applicable only to insurance was not properly taken. This view was accepted by the Board of Tax Appeals[8] and affirmed by the Circuit Court of Appeals for the First Circuit.[9] The court found that the contract was in the nature of an "invest-

3. For discussion of the difference between annuities and life insurance, in which their tax differences are emphasized, see Cohen, *Annuities and Transfer Taxes* (1938) 7 J. B. A. KAN. 139; (1939) 26 VA. L. REV. 230. The annuity treated here is to be distinguished from annuities arising under life insurance policies wherein the death benefit is paid out in annuity form.

4. Old Colony Trust Co. v. Comm'r, 102 F. (2d) 380 (C. C. A. 1st, 1939), *aff'g*, 37 B. T. A. 435 (1938). Chemical Bank & Trust Co., 37 B. T. A. 535 (1938) raised a similar question and was decided on the authority of the *Old Colony* case.

5. INT. REV. CODE § 811(g) (1939). "The value of the gross estate of the decedent shall be determined by including "(g) . . . the amount receivable by the executor as insurance . . . and . . . the amount receivable (in excess of $40,000) by all other beneficiaries as insurance under policies taken out by the decedent upon his own life."

6. Even though the purchase price is divided between the annuity and insurance features on the basis of actuarial experience. Thus, where the policy holder is 53 years old, about 60% of the purchase price goes to the insurance and 40% to the annuity, whereas in the case of an older purchaser the same company allocated 85% to the insurance and 15% to the annuity. See Bowman v. Tax Comm., 135 Ohio St. 295, 20 N. E. (2d) 916, 917 (1939); Ballou v. Fisher, 154 Ore. 548, 61 P. (2d) 423 (1936).

7. In Ballou v. Fisher, 154 Ore. 548, 61 P. (2d) 423 (1936) the requirement of the risk element was, likewise, stressed. In VANCE, INSURANCE (2d ed. 1930) §§ 3, 23, the contract of insurance is defined largely in terms of "risk" which is designated as one of the essential elements of an insurance contract. The Internal Revenue counsel conceded that the combination contract involved the assumption by the insurance company of some risk but this risk was not of an insurance nature; rather, it was an investment risk—that incident to the management and investment of the insured's funds.

8. Old Colony Trust Co., 37 B. T. A. 435 (1938).

9. Old Colony Trust Co. v. Comm'r, 102 F. (2d) 380 (C. C. A. 1st, 1939), 52 HARV. L. REV. 1180; see Comment (1940) 38 MICH. L. REV. 526.

ment"[10] with the insurance company from which the owner received a specified yearly income and, according to the terms of which, his beneficiaries received the "invested" principal if the owner had not previously claimed it by the surrender of his policy.

The recent decision of the Board of Tax Appeals in the *Keller* case[11] shortly dispelled any complacency that the tax authorities may have derived from the *Old Colony* victory, for the *Keller* decision disregarded the Commissioner's contention that the old device had reappeared in a more subtle form.[12] In that case, the decedent, aged 75, had entered into two separate contracts, one a single premium life insurance policy and the other a single premium annuity, each on the standard form used by the company in writing the respective policies. Although the premiums on each were independently figured at standard rates, the risk attached to the insurance of one of her age would have precluded the insured from buying the insurance policy unless she also purchased the annuity.[13] The same issue of the insurance exemption provided in Section 302(g) was again before the Board. The Board, stressing the independent nature of the contracts and distinguishing the earlier cases in which combination contracts were involved,[14] held that the two policies should be treated separately for taxation purposes.

The validity of the Board's distinction might not be questioned if the only situation involved were the $40,000 exemption from the federal estate tax. Since persons with sufficient resources to afford paid-up policies would normally be able to purchase additional insurance of the exempt type, it is probable that the insurance exemption would be used to its full extent even if it did not apply to the policies of the *Keller* type. But aside from this exemption, the Board's determination of the nature of the policies has serious implications in other tax connections.

10. "Investment" is used in this connection in the colloquial sense according to which usage stocks and bonds are termed "investments" while insurance is not so regarded. Functionally, life insurance in contrast with indemnity insurance is a form of investment. See VANCE, INSURANCE (2d ed. 1930) 26, 47, 75, 80. Although the terminology may thus be inapt, the distinction is nevertheless a valid one. The exemption provided by § 302(g) specifically applies to "insurance" and it is appropriate that the exemption be denied to other modes of saving, here termed "investments", if they do not have the essential elements of insurance.

11. Estate of Anna M. Keller, 39 B. T. A. 1047 (1939).

12. The combination type of policy, never very prominent, has been largely superseded by policies of the Keller type. Clark, *Taxation of Insurance Policies and Trusts* (1939) 4 JOHN MARSHALL L. Q. 445.

13. Persons over 70 or 75 are generally considered "uninsurable" and may purchase life insurance only in connection with a group plan or coupled with an annuity policy. Since there are few customers in the higher age groups, these provisions are made to enable the insurance companies to "hedge" their risks. But in annuities and group insurance the premiums are figured on the basis of the same mortality tables used in determining the rates for insurance policies which are independently purchased. See Estate of Anna M. Keller, 39 B. T. A. 1047, 1050 (1939).

14. Old Colony Trust Co. v. Comm'r, 102 F. (2d) 380 (C. C. A. 1st, 1939); Chemical Bank & Trust Co., 37 B. T. A. 535 (1938); *In re* Thornton's Estate, 186 Minn. 351, 243 N. W. 389 (1932); Ballou v. Fisher, 154 Ore. 548, 61 P. (2d) 423 (1936).

The *Keller* decision revives, in effect, a onetime favorite device for succession tax reduction. Until recently it was possible to avoid the federal estate tax by setting up an irrevocable trust with the reservation to the settlor of a life income from the trust property.[15] Since it was held that the irrevocable transfer of the trust property took the conveyance out of the testamentary class covered by the estate tax, even though the transferor received all of the benefits from the property until his death,[16] such transfers could be reached only by the gift tax,[17] which is 25% lower than the estate tax.[18] But an amendment to Section 302(c) of the Revenue Act put an end to this profitable use of the irrevocable trust by including within the estate tax "transfers by trust or otherwise . . . under which the transferor has retained . . . income from the property."[19] Under the *Keller* holding, however, it is now possible, by the joint purchase of separate insurance and annuity policies, to achieve a result similar to that once accomplished by means of the irrevocable trust.[20] The annuity policy provides its holder with a life income; the irrevocable inter vivos assignment of the paid-up insurance policy, with no benefits or incidents of ownership retained by the grantor, takes the conveyance out of the ambit of Section 302(c) as presently construed.[21] On the other hand, if the two policies were held to be inseparable, their procurement would be regarded as an "investment."[22] The holder's irrevocable transfer of the "insurance" rights could not then prevent the imposition of the estate tax on the benefit payable at his death,[23] since the yearly return to the investor would clearly identify the transaction as a

15. See Leaphart, *The Use of the Trust to Escape the Imposition of Federal Income and Estate Taxes* (1930) 15 CORN. L. Q. 587, 607; (1930) 44 HARV. L. REV. 131.

16. May v. Heiner, 281 U. S. 238 (1930).

17. The gift tax supplements the estate tax. Where a gift tax is paid on a transfer which is subsequently held testamentary, a credit for the gift tax payment is allowed on the estate tax. See INT. REV. CODE § 813(a)(2) (1939); Estate of Sanford v. Comm'r, 308 U. S. 39, 42, 45 (1939).

18. Tax savings in addition to the lower rate may be effected by the use of the gift tax. See MONTGOMERY AND MAGILL, FEDERAL TAXES ON ESTATES, TRUSTS, AND GIFTS, 1936-1937 (1936) 387 *et seq.*; (1939) 49 YALE L. J. 126.

19. INT. REV. CODE § 811(c) (1939). See Surrey and Aronson, *Inter Vivos Transfers and the Federal Estate Tax* (1932) 32 COL. L. REV. 1332, 1341 *et seq.*

20. Comment (1937) 32 ILL. L. REV. 223.

21. The transfer inter vivos of life insurance is subject to the gift tax. INT. REV. CODE § 1000 (1939). Bailey v. United States, 27 F. Supp. 617 (Ct. Cl. 1939) threw some doubt upon the tax status of such transfers. See (1939) 49 YALE L. J. 126. On rehearing, the opinion was modified, so that it now holds that the irrevocable assignment of life insurance on which the donor does not continue to pay premiums is not subject to the estate tax. Bailey v. United States, 30 F. Supp. 184 (Ct. Cl. 1939). *A fortiori*, the irrevocable assignment inter vivos of a policy on which no more premiums were due would not come within the estate tax.

22. See notes 8, 9 and 10 *supra*.

23. Although there are other ways in addition to that suggested by the *Keller* case in which to accomplish the purposes previously attained by the use of the irrevocable trust, these methods are not efficient. See *In re* Honeyman's Estate, 98 N. J. Eq. 638, 129 Atl. 393 (1925); Cohen, *Annuities and Transfer Taxes* (1938) 7 J. B. A. KAN. 139, 146 *et seq.*

"transfer . . . under which . . . the transferor . . . retained . . . the income . . ."[24]

The decision that an annuity and a life insurance policy purchased jointly are not an "investment" also makes possible the purchaser's reduction of his income tax. Two cases in state courts[25] and a recent Memorandum of the General Counsel of the Internal Revenue Bureau[26] indicate the form that such tax avoidance will take. The holder of the annuity and insurance policies will claim that his annual returns are received under an annuity policy, and, as annuities, represent a receipt of principal as well as interest.[27] He will then argue that the income tax on such payments should be determined in accordance with Section 22(b)(2) of the Internal Revenue Code,[28] the statutory provision applicable to annuities, which taxes only so much of an annuity as represents a return of interest.[29] The greater portion of each payment will thus be free from the income tax in most cases.[30] For example, assuming $12,000 is paid for an annuity which returns $1,200 yearly, and $30,000 is paid for a life insurance policy with a $40,000 death benefit, income tax under the *Keller* rule would be paid only on $360 (3% — the statutory figure — of $12,000). If, however, the two policies were considered as a unit, the entire return of $1,200 would represent income on a $40,000 "investment" and would therefore be taxable.

In light of the important differences for tax purposes between the combination contract of the *Old Colony* case and the two contracts involved in the *Keller* case, the basis for the Board's distinction between the two transactions cannot be disregarded. The Board purports to find an "entirely

24. INT. REV. CODE § 811(c) (1939). *Cf.* Burnet v. Whitehouse, 283 U. S. 148 (1930), in which the Court held that a fixed annual payment was taxable as an annuity where the payment was a charge upon both the income and corpus of a testamentary trust. That case is clearly distinguishable from the yearly payment on the "investment," for, by contract, the payment is a return on the investment and in no way diminishes the principal sum returnable at death or on the exercise of the surrender privilege.

25. Bowman v. Tax Comm., 135 Ohio St. 295, 20 N. E. (2d) 916 (1939); Ballou v. Fisher, 154 Ore. 548, 61 P. (2d) 423 (1936).

26. Gen. Counsel Memo. 21716 (1940), revoking Gen. Counsel Memo. 6395, VIII-1 CUM. BULL. 67 (1929). 4 Prentice-Hall 1940 Fed. Tax Serv. ¶ 66,068.

27. See Comment (1937) 11 TEMP. L. Q. 567, 568.

28. INT. REV. CODE § 22(b)(2) (1939). "Amounts received . . . under an annuity contract shall be included in gross income, except that there shall be excluded from gross income the excess . . . over an amount equal to three per centum of the aggregate premium . . . paid for such annuity (until the aggregate amount excluded for premiums . . . equals the aggregate premium)."

29. The statutory provision thus recognizes that annuity payments represent a return of principal with interest. The apparently arbitrary figure of 3% of the aggregate premium was established as the taxable return because of the belief that at least that much of the return represented interest and was taxable as income. It has been suggested that the tax is, in effect, a 6% tax, because it is figured on the basis of the original premium payment, part of which is consumed each year. See Comment (1937) 11 TEMP. L. Q. 567.

30. If the annuitant should live beyond his life expectancy, so that the aggregate amount paid in annuities less the amount taxed each year equalled the original cost of the annuity policy, subsequent annuity payments would be fully taxed. INT. REV. CODE § 22(b)(2) (1939).

different situation" in the *Keller* case but, on analysis, its reasoning appears to consist solely of reiteration that a "plain annuity" and a "plain, ordinary policy of insurance" are different from a "life annuity with principal sum payable at death."[31] Aside from separability, there was only one factual difference between the contracts in the *Keller* case and that in the *Old Colony* case:[32] while the particular annuity policy which the decedent Keller purchased for herself was not surrenderable either independently or in conjunction with the insurance policy, the surrender privilege of the combination policy in the *Old Colony* case included the annuity feature along with its life insurance feature. Because of the relative unimportance of the surrenderability of the annuity, this difference is hardly a sufficient reason to distinguish between the policies in the two cases. Since the purpose of the transaction in either scheme is the reduction of estate taxes, the policies are usually bought by persons with short life expectancies whose life insurance rates are high and whose annuity rates are correspondingly low. The annuity policy is therefore secondary in value to the surrenderable insurance policy. Furthermore, the buyer probably does not consider the surrender feature of the contracts of consequence, inasmuch as the exercise of this privilege involves the loss of a portion of the purchase price in the form of "loading charges."[33] But if the annuitant should wish to liquidate his nonsurrenderable annuity policy, he could probably sell his rights under the annuity contract for an amount approximating that part of the surrender value of the combination policy allocable to its annuity feature.[34] Thus, it is apparent that, as between the parties, the difference in the transactions was wholly formal and had no real functional or commercial significance.[35]

A possible explanation for the *Keller* decision may have been a belief by the Board that the transaction before it involved neither subterfuge nor the invention of a new tax evasion device, but rather tax avoidance through the orthodox use of traditional forms.[36] Under such circumstances, a decision by

31. Apparently in an effort to support its unconvincing distinction of the *Old Colony* case on purely formal grounds, the majority opinion makes an attempt to show the independence and "risky" nature of the annuity policy by pointing out that if the annuitant should outlive her life expectancy, as did her grandmother, the insurance company would lose on the annuity because of the extended period of the annuity payments. Estate of Anna M. Keller, 39 B. T. A. 1047, 1057 (1939). Actually, the length of the holder's life is a matter of indifference to the insurer because the gain or loss under one policy is counterbalanced by a corresponding loss or gain on the other.

32. One writer, after successfully isolating five additional, but formal, points of difference brought out in the *Keller* decision, suggests that they are all either immaterial or not distinctive. Comment (1940) 40 Col. L. Rev. 86, 87.

33. See note 2 *supra*. The possibility of the "loading" charge loss acting as a deterrent should not be minimized. Although it has been represented as 5% of the total premium in most of the cases discussed, it has tended to rise, so that now 10% is the usual charge. See Estate of Anna M. Keller, 39 B. T. A. 1047, 1051 (1939).

34. In the absence of a contract provision to the contrary, the annuitant's rights could be assigned. Restatement, Contracts (1932) §§ 150, 155.

35. If the *Keller* decision is followed there seems to be no reason why a present holder of the type of policy involved in the *Old Colony* case could not exchange it for policies of the *Keller* type and thus benefit by its tax advantages.

36. Tax statutes are supposedly drafted in terms of specific forms or objects and may be said to be limited to such objects in their application. See Reinecke v. Northern

the Board of Tax Appeals which leaves the question open for legislative solution was to be expected.[37] Further probing of the implications of the *Keller* case, however, uncovers a more deep-seated explanation for the decision. Profiting by the example of the Ohio Supreme Court in a recent case,[38] it may have considered analogous situations before making its decision. The Board's reluctance to hold the annuity and life insurance policies a unit would then be understandable, even if unjustified. Such a decision would bring before it a multitude of cases involving situations similar in principle but assuming an infinite variety of forms. If the two policies in question were to be considered as one, what of the case where two such policies are taken out in different companies? What if they were taken out at different times or if the annuity and life insurance were in proportions which did not readily lend themselves to the investment analogy? How to be treated are the great variety of annuities that an owner of life insurance might purchase?

In this explanation of the Board's decision there is a warning to the legislative or judicial body which undertakes to solve this problem.[39] If the solution is to be effective, it must take into account methods of tax avoidance analogous to that presented by the *Keller* case. The effect of purchasing the two policies in separate companies or at separate times is the same as buying them in the same company or in the same contract, since in all cases the premiums on each policy are figured independently and the fundamental relation between the two is unvaried. The annuity is always the reverse of life insurance.[40] Economically one counteracts and nullifies the other. The neutralizing effect of an annuity on a life insurance policy is thus not restricted to the case where the two are sold jointly; it is a phenomenon arising out of the mechanical workings of each of them whenever they are placed in juxtaposition.

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Trust Co., 278 U. S. 339, 348 (1928); PAUL, STUDIES IN FEDERAL TAXATION (1937) 29; *cf.* Pearson v. McGraw, 60 Sup. Ct. 211 (U. S. 1939); Helvering v. Hallock, 8 U. S. L. WEEK 192 (U. S. 1940).

37. An eminent tax authority has pointed out the desirability of leaving questions beyond the convenient flexibility of statutes for legislative solution. See Paul, *Life Insurance and the Federal Estate Tax* (1939) 52 HARV. L. REV. 1037, 1074 *et seq.*

38. Bowman v. Tax Comm., 135 Ohio St. 295, 20 N. E. (2d) 916 (1939). This case had a combination policy similar to that in the *Old Colony, Ballou* and *Thornton* cases, note 14 *supra*, but the Ohio court, deciding against the weight of those cases, reached a decision like that reached in the *Keller* case where separate policies were involved. One of the principal reasons given by the court for its decision was that the combination policy was similar in operation to separate annuity and insurance policies and the court would have held such policies taxable separately.

39. There will be ample opportunity for judicial attacks on this problem, since the *Keller* case and two others similar have been appealed. Estate of Anna M. Keller, 39 B. T. A. 1047 (1939) (on appeal to C. C. A. 3d); Estate of Cecile Le Gierse, 39 B. T. A. 1134 (1939) (on appeal to C. C. A. 2d); Estate of Herbert F. Tyler, B. T. A. memo op., 1 Prentice-Hall 1939 Fed. Tax. Serv. ¶ 6.504 (on appeal to C. C. A. 8th).

40. See Carroll v. Equitable Life Assur. Soc. of U. S., 9 F. Supp. 223, 224 (W. D. Mo. 1934); Comment (1937) 11 TEMP. L. Q. 567, 568.

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LABOR BOARD REINSTATEMENT OF EMPLOYEES OBTAINING SUBSTANTIALLY EQUIVALENT EMPLOYMENT*

AN important power of the Labor Board is derived from Section 10(c) of the National Labor Relations Act[1] whereby the Board is authorized to ". . . take such affirmative action, including reinstatement of employees with or without back pay, as will effectuate the policies of this Act . . ."[2] Pursuant to this provision, the Board has ordered the reinstatement of former employees who have obtained substantially equivalent employment,[3] notwithstanding the fact that an employee is defined in Section 2(3) to include ". . . any individual whose work has ceased as a consequence of, or in connection with any current labor dispute or because of any unfair labor practice, and who has not obtained . . . substantially equivalent employment . . ."[4] In support of this position, the Board has maintained that its reinstatement authority is not limited to the statutory rubric of "employees" within Section 2(3); and, further, that even if Section 2(3) does apply, workers who were "employees" at the date of the unfair labor practice may be ordered reinstated although they subsequently secure equivalent employment. But whenever challenged in the courts, these orders have been set aside on the ground that they had been issued without statutory authorization.[5] In spite of its continued failure to obtain judicial approval, the Board's most recent decision on this issue again ordered reinstatement of workers who had secured substantially equivalent employment elsewhere.[6]

The interpretation put upon the Act by the courts produces undesirable consequences. An individual who has ceased work because of a labor dispute or unfair labor practice, or who has been unlawfully discharged, will refrain from soliciting other employment in order to ensure the protection afforded

*Eagle-Picher Mining & Smelting Co., 5 LAB. REL. REP. index p. 283 (1939).

1. 49 STAT. 449 (1935), 29 U. S. C. § 151 *et seq.* (Supp. 1938).

2. 49 STAT. 453 (1935), 29 U. S. C. § 160(c) (Supp. 1938).

3. During the early administration of the Act, the Board ordered reinstatement of only those employees who had no equivalent work. N. L. R. B. v. Millfay Mfg. Co., Inc., 97 F. (2d) 1009 (C. C. A. 2d, 1938), *aff'g*, 2 N. L. R. B. 919 (1937); Rabhor Co., Inc., 1 N. L. R. B. 470 (1936). Because of the uncertainty of its present stand, the Board now decides whether or not a worker has received equivalent employment, but states that it does not concede a finding of no equivalent work is essential for reinstatement. See, *e.g.*, Automotive Maintenance Machinery Co., 13 N. L. R. B. 338 (1939); Southwestern Gas & Electric Co., 16 N. L. R. B. No. 54, Oct. 26, 1939.

4. 49 STAT. 450 (1935), 29 U. S. C. § 152(3) (Supp. 1938).

5. N. L. R. B. v. National Motor Bearing Co., 105 F. (2d) 652 (C. C. A. 9th, 1939); Mooresville Cotton Mills v. N. L. R. B., 94 F. (2d) 61 (C. C. A. 4th, 1938), *on rehearing*, 97 F. (2d) 959 (1938); N. L. R. B. v. Carlisle Lumber Co., 94 F. (2d) 138 (C. C. A. 9th, 1937), *cert. denied*, 304 U. S. 575 (1938), *enforcement of supplemental order granted*, 99 F. (2d) 533 (C. C. A. 9th, 1938), *cert. denied*, 306 U. S. 646 (1939). A decision in the Second Circuit on a different issue indicates that a like treatment awaits such an order if squarely presented. See N. L. R. B. v. National Casket Co., 5 LAB. REL. REP. index p. 437 (C. C. A. 2d, 1939), L. Hand, J., dissenting.

6. Eagle-Picher Mining & Smelting Co., 5 LAB. REL. REP. index p. 283 (1939).

by the statute.[7] His period of idleness will thus be prolonged and the employer who has violated the Act will be required to bear an increased burden of back pay.[8] In addition to needless hardship on employer and employee, the interpretation permits a circumvention of statutory objectives. Experience has shown that employers frequently discriminate against union leaders in their employ in the attempt to cripple a labor organization.[9] Under the courts' decisions, this discrimination may proceed with impunity, despite the union's loss of essential membership, if the worker, driven by economic necessity,[10] seeks and finds equivalent employment. Such results can hardly be said to promote industrial peace or to prevent employers from profiting by unfair labor practices.[11]

A practical objection to this judicial qualification of the Board's authority is revealed by an appraisal of the consequences attached to the definition of "substantially equivalent employment." In defining the term the Board gives greater weight to the desire of the employee to return to familiar surroundings than to the fact that his new position pays higher wages.[12] If longer commuting is required,[13] if seniority rights are sacrificed[14] and if the new position does not assure continued employment,[15] there is no substantially

7. Since a back pay order is not a private right of the employee but is issued in the public interest, an employee has no obligation to mitigate the amount of back pay by soliciting other employment. See Agwilines, Inc. v. N. L. R. B., 87 F. (2d) 146 (C. C. A. 5th, 1936), N. L. R. B., 4TH ANN. REP. 100 (1940); (1939) 48 YALE L. J. 1265, 1267. The Act has been criticized for permitting an employee to "sleep on his rights." *Hearings before Committee on Education and Labor on S. 1264, S. 1392, S. 1550, S. 1580, and S. 2123*, 76th Cong., 1st Sess. (1939), as reported in 4 LAB. REL. REP. index p. 593 (1939).

8. For an analysis of how back pay orders are computed, see (1939) 48 YALE L. J. 1265.

9. See, *e.g.*, Planters Mfg. Co., 10 N. L. R. B. 735 (1938); Precisions Castings Co., 8 N. L. R. B. 879 (1938).

10. There is a long period of uncertainty during which the status of an employee, whose employer is charged with violating the Act, is undetermined. The disposition of 1,353 cases through Dec. 31, 1938, filed by the AFL and CIO shows that the combined average of all cases took 293 days from the original charge to the final decision. REPORT OF THE NLRB TO SEN. COMM. ON EDUC. AND LABOR (1939) 4 LAB. REL. REP. index p. 247. An amendment proposed by the AFL would reduce this period to four months and ten days. See (1939) 4 LAB. REL. REP. index p. 460.

11. Equivalent employment does not serve the Act's purpose since its objectives are preventative and not simply to remunerate employees. SEN. REP. No. 573, 74th Cong., 1st Sess. (1935) 1, 6; H. R. REP. No. 1147, 74th Cong., 1st Sess. (1935) 9; Consolidated Edison Co. v. N. L. R. B., 305 U. S. 197 (1938); N. L. R. B. v. Mackay Radio & Tel. Co., 304 U. S. 335 (1938); see Comment (1938) 26 CALIF. L. REV. 354.

12. Planters Mfg. Co., 10 N. L. R. B. 735 (1938); Tiny Town Togs, 7 N. L. R. B. 54 (1938); Kelley-Springfield Tire Co., 6 N. L. R. B. 325 (1938); but see N. L. R. B. v. Botony Worsted Mills, Inc., 4 LAB. REL. REP. index p. 894 (C. C. A. 3d, 1939), where the court refused to sustain a finding based only on the employee's preference. See (1939) 52 HARV. L. REV. 1365.

13. Boss Mfg. Co., 11 N. L. R. B. 432 (1939); Kuehne Mfg. Co., 7 N. L. R. B. 304 (1938).

14. Southwestern Gas & Electric Co., 16 N. L. R. B. No. 54, Oct. 26, 1937.

15. Pulaski Veneer Corp.. 10 N. L. R. B. 136 (1938).

equivalent employment. It is evident that the Board's strict evaluation of the new employment means that a slight variation will preclude a finding in the majority of cases that the subsequent work is a substantial equivalent of the previous position. This determination is a question of fact within the discretion of the Board,[16] and, if supported by substantial evidence, is conclusive.[17] It is questionable policy for the courts to establish a rule of law which the Board can effectively and lawfully avoid, through the use of its fact finding power, by proceeding to find no substantially equivalent employment. A realistic approach by the courts would be to recognize that their present limitations on the Board's authority do little more than add another step to the administrative investigation of the "employee's" status.

The Board's construction of Section 2(3) avoids these unfortunate results and is more consonant with the policies of the Act. Under its interpretation, "equivalent employment" envisages a condition at the date of the unfair labor practice and, therefore, this time is the dividing line that determines when equivalent employment will destroy the worker's standing as an "employee." No consideration of other employment thus is necessary when the employer-employee relationship exists either at the time of a discriminatory discharge, or when employees leave work because of unfair labor practices. In these cases, of course, workers would be "employees" at the time of the unfair labor practice. The equivalent employment provision would be relevant only when employees are already on strike because of a labor dispute. In this situation, the time of the employer's unlawful conduct would be decisive. If a worker, idle because of a labor dispute, accepted an equivalent position, he would be ineligible for reinstatement, although subsequently during the course of the strike the employer committed an unfair labor practice.[18] But those securing employment after the discriminatory act would not be barred from relief.[19] This interpretation appears to be warranted because, if Section 2(3) is held to apply, its ambiguities — created by the lack of any indication of the time other employment might bar reinstatement[20] — should be resolved

16. Mooresville Cotton Mills v. N. L. R. B., 97 F. (2d) 959 (C. C. A. 4th, 1938).

17. See N. L. R. B. v. Columbian Enameling & Stamping Co., 306 U. S. 292, 299 (1939); Consolidated Edison v. N. L. R. B., 305 U. S. 197, 229 (1938).

18. A prerequisite to reinstatement is an unfair labor practice by the employer. N. L. R. B. v. Mackay Radio & Tel. Co., 304 U. S. 333, 345, 346 (1938); Black Diamond S. S. Corp., 94 F. (2d) 875 (C. C. A. 2d, 1938), *cert. denied*, 304 U. S. 579 (1938). Employees on strike (caused by no unfair labor practice) cannot be reinstated after the employer has resumed normal operations. N. L. R. B. v. Columbian Enameling & Stamping Co., 306 U. S. 292 (1939). See N. L. R. B., 3D ANN. REP. 199-204 (1939).

19. Since an employer may unlawfully prolong a strike that was originally due to a labor dispute and not to any unfair labor practice, the Board has ordered reinstatement following the employer's unlawful conduct during the strike. N. L. R. B. v. Remington Rand, Inc., 94 F. (2d) 862 (C. C. A. 2d, 1938), *cert. denied*, 304 U. S. 576 (1938), *rehearing denied*, 304 U. S. 590 (1938). See N. L. R. B., 4TH ANN. REP. 104, 105 (1940).

20. Other employment might be obtained after the unfair labor practice but before either the charge, the complaint, the hearing before the trial examiner, the hearing before the Board, the Board's order, or the final decree of the court. See RULES AND REGULATIONS FOR N. L. R. B., Art. II; 1939 WIS. L. REV. 445, 453.

in a manner that will protect all workers subjected to an unfair labor practice.[21]

An obstacle to the Board's flexible interpretation of Section 2(3) lies in the fact that, for purposes other than reinstatement and back pay, workers securing equivalent employment *after* an unfair labor practice would not be subject to the Act.[22] Influenced perhaps by this inconsistency, the circuit court in *Mooresville Cotton Mills v. National Labor Relations Board*,[23] stated that the section was unambiguous, and that "employees" were disqualified *whenever* equivalent work was accepted. This decision, if followed, would result in overwhelming complexities, because a continuous surveillance of the status of "employees" would be required until the time of reinstatement ordered by the Board and, if the order were challenged, until there had been a final adjudication in the courts. Decisions of the Supreme Court granting reinstatement long after the date of the unfair labor practice, without remanding the case for further investigation,[24] signify that this interpretation is not correct. The point of view expressed in the *Carlisle Lumber* case,[25] that "employees" were disqualified if they had secured other employment at the time of the Board's order, is likewise objectionable because it prolongs the period of uncertainty during which employees will refrain from soliciting other employment; and individuals who are employees at the time of the unfair labor practice, but accept a position prior to the order, will be denied the remedies furnished by the Act.

In addition to the reasons previously stated, further considerations indicate that, regardless of the proper construction of Section 2(3), the Board's affirmative authority should not be restricted to "employees."[26] Authority

21. Ambiguous statutes should be interpreted to facilitate their obvious aims. Royal Indemnity Co. v. American Bond & Mortgage Co., 289 U. S. 165, 169 (1933); Wilbur v. United States *ex rel.* Kadrie, 281 U. S. 206, 219 (1930); Work v. United States *ex rel.* Rives, 267 U. S. 175, 177 (1925). True collective bargaining requires that all workers be protected from discrimination. See SEN. REP. No. 573, 74th Cong., 1st Sess. 6 (1935); Hart and Prichard, *The Fansteel Case: Employee Misconduct and the Remedial Powers of the National Labor Relations Board* (1939) 52 HARV. L. REV. 1275; Nathanson and Lyons, *Judicial Review of the National Labor Relations Board* (1939) 33 ILL. L. REV. 749.

22. See notes 33, 34 and 35 *infra*.

23. 94 F. (2d) 61 (C. C. A. 4th, 1938), *on rehearing*, 97 F. (2d) 959 (1938).

24. See, *e.g.*, N. L. R. B. v. Mackay Radio & Tel. Co., 304 U. S. 333 (1938). Likewise, a controversy was not rendered moot because the employer subsequently complied with the Act. N. L. R. B. v. Pennsylvania Greyhound Lines, Inc., 303 U. S. 261 (1938).

25. 94 F. (2d) 138 (C. C. A. 9th, 1937), *cert. denied*, 304 U. S. 575 (1938), *enforcement of supplemental order granted*, 99 F. (2d) 533 (1938), *cert. denied*, 306 U. S. 646 (1939).

26. The Supreme Court has not passed on the precise issue involved when strangers are compelled to enter an employer-employee relationship. Although a laborer who secured equivalent employment may not be an "employee" within Section 2(3), he is surely not a stranger to his previous employer. But if he is considered to be a stranger, authority for his reinstatement may be drawn from other decisions of the Court on analogous issues. See Eastern States Retail Lumber Dealers' Ass'n v. United States, 234 U. S. 600 (1914) (enjoined a conspiracy under the Sherman Act from refraining to contract); New York Central R. R. v. White, 243 U. S. 188 (1917) (compulsory workmen's com-

for back pay is expressly given only in Section 10(c), where it is coupled with reinstatement orders. If reinstatement is restricted to "employees," it follows that back pay is likewise so restricted. This, in fact, has been the position of the Ninth Circuit.[27] But Congress certainly did not intend to deprive an "employee" of the back pay necessary to recompense him for injuries incurred prior to obtaining an equivalent position.[28] Recognizing this segment of legislative intent, the Fourth Circuit Court of Appeals affirmed an order of back pay to workers who had accepted equivalent employment, but set aside the order of reinstatement on the ground that the workers were no longer "employees."[29] Since the court felt justified in awarding back pay to those whom it did not consider "employees," no reason appears why there was not equal justification for the same conclusion as to reinstatement. A restriction of the scope of affirmative orders to "employees" would also impair the provision in Section 8(3)[30] which declares that it shall be unlawful to encourage or discourage membership in any labor organization by discrimination in regard to *hire*. One who is only seeking employment is obviously not an "employee." Hence an individual who is denied employment because of union affiliations would be without an effective remedy.[31]

Since it appears unlikely that Congress intended to emasculate these provisions by limiting their application to "employees" as defined in Section 2(3),[32] the present judicial construction appears untenable. The definition

pensation contracts); *Ex parte* McNiel, 13 Wall. 236 (U. S. 1871) (implied contract for compensation of first pilot tendering his services to an incoming vessel); (1939) 53 HARV. L. REV. 141; *cf.* (1924) 33 YALE L. J. 667. See note 31 *infra.*

27. N. L. R. B. v. Carlisle Lumber Co., 94 F. (2d) 138 (C. C. A. 9th, 1937), *cert. denied*, 304 U. S. 575 (1938), *enforcement of supplemental order granted*, 99 F. (2d) 533 (C. C. A. 9th, 1938), *cert. denied*, 306 U. S. 646 (1939); N. L. R. B. v. National Motor Bearing Co., 105 F. (2d) 652 (C. C. A. 9th, 1939). But see where the same circuit awarded back pay to the estate of an employee who died subsequent to the date of the Board's order. N. L. R. B. v. Hearst Publications, 102 F. (2d) 658 (C. C. A. 9th, 1939).

28. SEN. REP. No. 1147, 74th Cong., 1st Sess. (1935) 23, 24. One of the objectives of the Act is to restore the status quo, and this will not obtain if an employee must bear the burden of an unfair labor practice. See Black Diamond Steamship Corp. v. N. L. R. B., 94 F. (2d) 875, 879 (C. C. A. 2d, 1938), *cert. denied*, 304 U. S. 579 (1938); N. L. R. B. v. Remington Rand, Inc., 94 F. (2d) 862, 872 (C. C. A. 2d, 1928), *cert. denied*, 304 U. S. 576 (1938).

29. Mooresville Cotton Mills v. N. L. R. B., 94 F. (2d) 61 (C. C. A. 4th, 1938), *on rehearing*, 97 F. (2d) 959 (1938). See (1939) 48 YALE L. J. 1265, 1269.

30. 49 STAT. 452 (1935), 29 U. S. C. § 158(3) (Supp. 1938).

31. In one instance the Board ordered an employer to hire individuals who had never previously been in his employ. Waumbic Mills, Inc., 15 N. L. R. B. No. 4, Sept. 1, 1939. See (1939) 53 HARV. L. REV. 141. This remedy was clearly contemplated by Congress. See H. R. REP. No. 1147, 74th Cong., 1st Sess. (1935) 19. The only analogous judicial decision on this question set aside the Board's order to hire former employees (lawfully discharged prior to the effective date of the Act) whom the employer discriminatorily refused to employ. N. L. R. B. v. National Casket Co., 5 LAB. REL. REP. index p. 437 (C. C. A. 2d, 1939), L. Hand, J., dissenting.

32. *Cf.* N. L. R. B. v. Griswold Mfg. Co., 106 F. (2d) 713, 722 (C. C. A. 3d, 1939); N. L. R. B. v. Biles Coleman Lumber Co., 98 F. (2d) 18, 23 (C. C. A. 9th, 1938).

of an "employee" in Section 2(3) is essential for a practical administration of other sections: to determine with whom the employer must bargain collectively;[33] to ascertain those persons whose rights to self-organization are protected from interference by the employer;[34] and to delimit the class of individuals who are entitled to vote in an election or otherwise participate in the designation of representatives.[35] The definition is not indispensable, however, for a determination of how the objectives of the Act may be achieved under Section 10(c). An adventitious comparison of prior and subsequent employment can have little bearing on the question whether reinstatement of certain employees would fortify industrial peace. To secure complete consistency of purpose between all sections of the statute, the specific provision — "including reinstatement of employees with or without back pay" — should be construed as words of illustration rather than limitation of the general grant of power to take affirmative action.[36] In the *Fansteel* case, the Supreme Court avoided a direct decision on this question of construction.[37] Since the issue before the court was more readily determinable if the words were construed as those of limitation, there is some indication that the court does not so interpret the statute. Any permissible inferences from the *Fansteel* decision are augmented by previous cases where the court has upheld affirmative orders not expressly mentioned in Section 10(c), such as posting of notices[38] and disestablishment of employer-dominated labor organizations.[39] It appears, therefore, that the most satisfactory construction of the Act is to grant the Board the discretionary power to reinstate workers even though they may no longer be "employees" and regardless of whether they have obtained substantially equivalent employment elsewhere.

33. When workers have received equivalent work they cannot be considered when deciding whether an employer has refused to bargain collectively with a majority of his "employees." Standard Lime & Stone Co. v. N. L. R. B., 97 F. (2d) 531 (C. C. A. 4th, 1938).

34. See N. L. R. B., 4TH ANN. REP. 64-69 (1940).

35. See *id.* at 73-82.

36. The *expressio unius* maxim is useful only to discover intent and falls when a contrary policy is shown. See Helvering v. Morgan's, Inc., 293 U. S. 121, 125 n. (1934); Springer v. Philippine Islands, 277 U. S. 189, 206 (1928); but see Missouri v. Ross, 299 U. S. 72, 76 (1936); D. Ginsberg & Sons v. Popkin, 285 U. S. 204, 208 (1932).

37. The basis of the Court's decision was that the reinstatement ordered by the Board would not effectuate the policies of the Act. N. L. R. B. v. Fansteel Metallurgical Corp., 306 U. S. 240, 258 (1939). Mr. Justice Stone, concurring, stated directly that workers who were not "employees" within Section 2(3) could not be reinstated. *Id.* at 263. The lower court's position was similar to Justice Stone's. Fansteel Metallurgical Corp. v. N. L. R. B., 98 F. (2d) 375, 382 (C. C. A. 7th, 1938).

38. N. L. R. B. v. Pennsylvania Greyhound Lines, 303 U. S. 261 (1938); N. L. R. B., 4TH ANN. REP. 109 (1940).

39. N. L. R. B. v. Pennsylvania Greyhound Lines, 303 U. S. 261 (1938); N. L. R. B. v. Pacific Greyhound Lines, 303 U. S. 272 (1938); N. L. R. B., 4TH. ANN. REP. 98 (1940).

JUDGMENT ON MERITS AS RES JUDICATA OF JURISDICTION OVER SUBJECT MATTER*

THE doctrine that a judgment rendered by a court without jurisdiction over the subject matter of the suit is void and subject to collateral attack in any court at any time[1] has long obstructed nationwide administration of judgments. This rule, a result of a conception of jurisdiction as a power to adjudicate bestowed upon a court from a sovereign source,[2] has conflicted with the practical need that judgments be made conclusive.[3] To preserve the legend of jurisdictional vulnerability while giving at the same time fixity to judgments, courts have devised such legalistic dodges as presumptions of regularity,[4] estoppels[5] and classes of inviolable quasi-jurisdictional facts.[6] No theory was effective, however, in making judgments unassailable — particularly in foreign courts — until the concept of res judicata[7] was introduced into the field of subject matter jurisdiction by the United States Supreme Court, the tribunal most interested in making judgments conclusive through-

*Chicot County Drainage Dist. v. Baxter State Bank, 60 Sup. Ct. 317 (U. S. 1940).

1. 1 FREEMAN, JUDGMENTS (5th ed. 1925) 668; 1 BAILEY, JURISDICTION (1899) 136.

2. See United States v. Arredondo, 6 Pet. 691, 709 (U. S. 1832); Rhode Island v. Massachusetts, 12 Pet. 657, 718 (U. S. 1838); 1 BAILEY, JURISDICTION (1899) 2.

3. The perpetual vulnerability of judgments on jurisdictional grounds made judgment titles unmarketable, gave no effect to rights acquired in reliance upon judicial records and permitted parties to relitigate the same issues interminably. Reexamination of jurisdictional questions in foreign states or in federal courts tripled a party's opportunities to upset an unfavorable decision. See diagrams in ARNOLD AND JAMES, CASES ON TRIALS, JUDGMENTS AND APPEALS (1936) 134-35.

4. A judgment fair on its face is presumed to be valid and conclusive as to the regularity of all steps necessary in acquiring jurisdiction. Applegate v. Lexington & Carter County Mining Co., 117 U. S. 255 (1886); (1936) 46 YALE L. J. 159, 160. The presumption has been extended to validate a judgment showing lack of jurisdiction on its face. Des Moines Navigation & Ry. v. Iowa Homestead Co., 123 U. S. 552 (1887). But this presumption has never been applied to judgments of sister states. 1 FREEMAN, JUDGMENTS (5th ed. 1925) 781.

5. The doctrine of estoppel forbids attack upon invalid divorce decrees by spouses who participated in or relied upon the decree. Langewald v. Langewald, 234 Mass. 269, 125 N. E. 566 (1920); RESTATEMENT, CONFLICT OF LAWS (1934) § 112; 3 FREEMAN, JUDGMENTS (5th ed. 1925) 2962.

6. "Quasi-jurisdictional facts" are those facts, such as the situs of matrimonial domicil, diversity of citizenship, or amount in controversy, which form the basis for the conclusions of law as to jurisdiction. Since they are not strictly jurisdictional, they are impregnable against collateral attack. See Noble v. Union R. L. R. R., 147 U. S. 165, 173 (1893).

7. Res judicata, originally a simple rule of convenience preventing a party from burdening the courts with the same matter more than once, had been crystallized by nineteenth century judges and glossators into a congeries of formal rules and maxims centering about the doctrines: (1) that in a new suit between the same parties on a different cause of action, the prior judgment is conclusive upon all points passed upon by the court, (estoppel by verdict), and (2) that in a new suit between the same parties on the same cause of action, the prior judgment is conclusive upon all points which might there have been raised (estoppel by judgment). See Cromwell v. Sac, 94 U. S. 351, 352-353 (1876).

out the nation. The federal courts had earlier applied res judicata to personal jurisdiction in cases giving conclusive effect to rulings made upon special appearance,[8] on the rationale that a party who came in and litigated the issue of personal jurisdiction impliedly agreed to be bound by a decision, though erroneous.[9] The obstacle of supposed unwaivability which had prevented the extension of res judicata to subject matter jurisdiction was first prominently[10] spanned in *American Surety Company v. Baldwin*,[11] followed by *Stoll v. Gottlieb*[12] — cases in which the original court had made a specific though incorrect finding of its own power to judge. The "jurisdictional bootstrap" argument — that a jurisdictionless court could not clothe itself with power by making a finding that it possessed jurisdiction — was rejected in favor of the view that an express finding of jurisdiction, like any other judicial act, should be given the effect of res judicata.[13] The power concept of jurisdiction was forced to yield before the practical need for terminating litigation.

In terms of fairness to individual litigants, however, the application of res judicata to the question of jurisdiction could hardly have been termed successful. Clumsy wielding of the strict and formal rules of res judicata supplied new evils to replace those of jurisdictional vulnerability. The first prominent application of the doctrine, in *American Surety Company v. Baldwin*, gave conclusive effect to an *ex parte* judgment rendered without hearing against a surety on a bond on which it was in no way liable.[14] Rigid application of the rule flouted legislative policy and aided in the perpetuation of wrong decisions.[15]

A new approach to jurisdictional res judicata is heralded by the Supreme Court's recent decision in *Chicot County Drainage District v. Baxter State Bank*.[16] Chapter IX of the Bankruptcy Act of 1934[17] empowered federal district courts to sanction municipal debt readjustments. The defendant Chicot district, complying strictly with the terms of Chapter IX, entered into an arrangement whereby its outstanding bonds were exchanged for new securi-

8. Comment (1940) 53 HARV. L. REV. 652, 656.

9. See Baldwin v. Iowa State Traveling Men's Ass'n, 283 U. S. 522, 525 (1931).

10. A few early decisions applied res judicata to subject matter jurisdiction in special situations. Dowell v. Applegate, 152 U. S. 327 (1894) (diversity of citizenship); Forsyth v. Hammond, 166 U. S. 506 (1897) (jurisdiction of original court upheld on appeal); Chicago, R. I. & P. Ry. v. Schendel, 270 U. S. 611 (1926) (intrastate commerce).

11. 287 U. S. 156 (1932), (1933) 42 YALE L. J. 427.

12. 305 U. S. 165 (1938), (1939) 48 YALE L. J. 879, 39 COL. L. REV. 274.

13. See Stoll v. Gottlieb, 305 U. S. 165, 172 (1938). The Court refused to decide whether land and status cases were included in the rule of jurisdictional res judicata, but other recent cases point to universal application of the rule. Davis v. Davis, 305 U. S. 32 (1938); Chicot County Drainage Dist. v. Baxter State Bank, 60 Sup. Ct. 317 (U. S. 1940). *But cf.* Kalb v. Feuerstein, 60 Sup. Ct. 343 (U. S. 1940).

14. See 287 U. S. 156, 159-61 (1932); Baldwin v. Anderson, 50 Idaho 606, 621, 299 Pac. 341, 346 (1931).

15. *E.g.*, Reid v. Independent Union, 200 Minn. 599; 275 N.W. 300 (1937); Treinies v. Sunshine Mining Co., 308 U. S. 66 (1939).

16. 60 Sup. Ct. 317 (U. S. 1940).

17. 48 STAT. 798 (1934); 11 U. S. C. § 301 (1934).

ties on the basis of thirty-six cents on the dollar, and a scheme of refinancing executed through the RFC. Plaintiff bondholders were admittedly given full notice of the plan but they neither exchanged their bonds nor contested the reorganization. Two months after the entry of the bankruptcy court's final decree, Chapter IX was held unconstitutional by the Supreme Court.[18] Plaintiffs later sued in the federal district court for the face value of their bonds. The Chicot district's plea of the bankruptcy decree as res judicata was overruled by the district court and by the circuit court of appeals[19] on the ground that a decree whose jurisdiction was founded upon an unconstitutional statute was void and incapable of functioning as res judicata. The Supreme Court reversed, holding that plaintiffs were precluded from attacking the decree, despite the later unconstitutionality of Chapter IX. Plaintiffs were bound because they had not originally contested or appealed the question of the court's jurisdiction although they had full notice and opportunity to do so, because rights had vested in reliance upon the decree's validity, and because all parties had treated the statute and decree as operative and binding facts. Mr. Chief Justice Hughes' opinion is remarkable for its quiet empirical tone, eschewing the categorical approach of earlier courts to this problem in favor of an examination into the practical difficulties involved in voiding the decree.

The case extends the union of res judicata and jurisdiction over the subject matter to the situation where the issue of jurisdiction has neither been contested nor expressly decided by the court.[20] By thus making every judgment where defendant has been given notice and has failed to contest jurisdiction conclusive upon the question of the court's jurisdiction over the subject matter,[21] the court has effectively disposed of the old saw that "jurisdiction over the subject matter may not be waived." The case places the burden upon the parties to raise the question of subject matter jurisdiction in the original proceeding or be deemed to have waived the issue. In superseding the requirement that the court make a formal finding of its jurisdiction, the Supreme Court is giving effect to the necessary implication of each judgment that the delivering court has the requisite power to adjudicate. It is also properly emphasizing the fact that the decree was treated by the parties at

18. Ashton v. Cameron County Water Improvement Dist., 298 U. S. 513 (1936).

19. Chicot County Drainage Dist. v. Baxter State Bank, 103 F. (2d) 847 (C. C. A. 8th, 1939).

20. See also Windholz v. Everett, 74 F. (2d) 834 (C. C. A. 4th, 1935) (federal jurisdiction implied from ruling on merits).

21. The rule is not, however, without exception. Where an overriding policy demands that a court yield its jurisdiction over a res to a superior tribunal with plenary jurisdiction over the subject matter, the proceedings of the first court will still be subject to collateral attack. Kalb v. Feuerstein, 60 Sup. Ct. 343 (U. S. 1940) (filing of bankruptcy petition under Frazier-Lemke Act held automatically to oust jurisdiction of state court over proceedings to foreclose mortgage on debtor's farm and to subject sale and dispossession authorized by state court to collateral attack); *cf.* First Nat. Bank v. Robinson, 107 F. (2d) 50 (C. C. A. 10th, 1939). This approach seems proper wherever public interest in limiting a court's jurisdiction overbalances the policy of terminating litigation. Thus a court should not be permitted to give the effect of res judicata to a labor injunction issued in violation of an anti-injunction statute. *But cf.* Reid v. Independent Union, 200 Minn. 599, 275 N. W. 300 (1937).

the time as a binding and valid judgment rather than stressing the purely formal fact of a recital of jurisdiction. In addition, it disposes of the paradoxical result of the *Baldwin* rule in binding a party who objects to jurisdiction if the original trial and appellate courts disagree with him, but permitting a party who voluntarily participates in the original proceeding later to attack it.

The *Chicot* case is important also in marking the Supreme Court's express repudiation of the theory than an unconstitutional statute is a nullity which can confer no rights[22] — a dogma which has been largely hacked away by exception[23] and generally abandoned by state and lower federal courts.[24] By regarding the statute as an existing reality, as the parties at the time regarded it, rather than with the hindsight language of "void ab initio," by giving effect to the heavy investments made in reliance on the validity of the statute and decree, and by requiring parties to raise the constitutional issue or be regarded as having waived it, the court shows its understanding that the question of unconstitutionality is a practical problem in political administration which must be handled differently for each type of situation.[25] In addition, the case marks the application of the *Sunburst* case[26] doctrine — that changes in the law will be given only prospective and not retrospective effect when parties have made acquisitions on the strength of the existing law — to the situation of a statute regarded as valid but later found unconstitutional; another indication that the idea of "action in reliance" is obtaining its deserved respect from the Court.

Perhaps the greatest significance of the decision lies in its replacing the mechanical treatment of res judicata which has been evident in recent Supreme

22. Norton v. Shelby County, 118 U. S. 425 (1886); Security Sav. Bank v. Connell, 198 Iowa 564, 200 N. W. 8 (1924). See Chicago, I. & L. Ry. v. Hackett, 228 U. S. 559, 566 (1913); 1 BAILEY, JURISDICTION (1899) 11.

23. The de facto doctrine has saved several decisions made by courts acting in excess of their constitutional powers. Burt v. Winona & St. P. R. R., 31 Minn. 472, 18 N. W. 285 (1884); FIELD, THE EFFECT OF AN UNCONSTITUTIONAL STATUTE (1935) 113–118. Where parties have relied upon a statute's validity, the courts will protect them. Ross & Co. v. Road Dist. No. 4, 27 F. (2d) 153 (E. D. Tex. 1928). Those who accept the conditions of a statute are estopped from later attacking its unconstitutionality. Pierce Oil Corp. v. Phoenix Refining Co., 259 U. S. 125 (1922). A constitutional attack must be raised in the trial court or be waived. Wong Tai v. United States, 273 U. S. 77 (1927). But in criminal cases, a conviction under an unconstitutional statute may always be attacked by habeas corpus. *Ex parte* Siebold, 100 U. S. 371 (1880); Servonitz v. State, 133 Wis. 231, 113 N. W. 277 (1907).

24. Woods Bros. Const. Co. v. Yankton County, 54 F. (2d) 304 (C. C. A. 8th, 1931); Herndon v. Moore, 18 S. C. 339 (1882); Beck v. State, 196 Wis. 242, 219 N. W. 197, (1928), *cert. denied,* 278 U. S. 639 (1928); Jones v. McGrath, 160 Okl. 211, 16 P. (2d) 853 (1932).

25. Compare with the instant case's treatment of unconstitutionality, that of Kalb v. Feuerstein, 60 Sup. Ct. 343 (U. S. 1940) discussed *supra* note 21, in which a state foreclosure proceeding conflicting with the constitutional provision granting Congress full power over bankruptcies was held void and not res judicata of state court's jurisdiction over subject matter. See also (1926) 39 HARV. L. REV. 373; (1929) 29 COL. L. REV. 1140.

26. Great Northern Ry. v. Sunburst Oil & Refining Co., 287 U. S. 358 (1932).

Court decisions[27] with a broad and sensible approach to the subject. In determining that the issue of jurisdiction is res judicata because the plaintiff could have raised it in the previous suit (and thus implying that the readjustment proceeding and the present suit are the same cause of action), the court bypasses without discussion such niceties as the fact that the present suit is *in personam* while the bankruptcy arrangement was *in rem*, and other distinctions which would show the two proceedings to be different causes of action. This easy handling of the technical rules of res judicata shows a proper treatment of the problem which should not be regarded as a system of rigid formulae but as a simple canon assuring each litigant one full and fair opportunity to present his arguments before a disinterested arbiter.[28] A party who fails to seize this opportunity should not be permitted to raise the issue later on the basis of some technical informality.

Other tribunals may, however, be less adept than the Supreme Court in leaping doctrinal hurdles in the path of a fair result by the process of ignoring them. The easiest method for achieving the desirable result of the *Chicot* case in other courts with the tools now at hand, seems to be by giving the widest possible scope to the idea of a cause of action, upon which res judicata depends. In other connections, the Supreme Court has regarded a cause of action broadly — as the aggregate of operative facts making up the original transaction.[29] Such a workable interpretation of a cause of action would permit flexible manipulation of res judicata. If the previous case was so presented that there was a fair opportunity to contest the jurisdictional issue now sought to be raised, res judicata should bar its further relitigation.

The *Chicot* decision also holds great potentialities for making judgments conclusive in foreign forums. Although judges have emasculated the phrase "full faith and credit" to permit foreign courts to attack any judgment on jurisdictional grounds,[30] the words "res judicata" still inspire respect. Res judicata has already superseded inquiry into subject matter jurisdiction between state and federal courts.[31] If the Court is consistent in applying

27. Oklahoma Packing Co. v. Oklahoma Gas & Electric Co., 7 U. S. L. WEEK 644 (U. S. 1939), *opinion withdrawn*, (1940) 8 U. S. L. WEEK 126 (state court's review of rate order, regarded at time as legislative review incapable of generating res judicata and without right of appeal to United States Supreme Court on federal question, given effect of res judicata by retroactive application of later state decision holding such review to be judicial); Reed v. Allen, 286 U. S. 191 (1932); Treinies v. Sunshine Mining Co., 308 U. S. 66 (1939).

28. See 1 MOORE, FEDERAL PRACTICE (1938) 160; Von Moschzisker, *Res Judicata* (1929) 38 YALE L. J. 299, 300. The suggestion has been made that a judgment rendered by a court without jurisdiction after a hearing be treated as a binding arbitration. Gavit, *Jurisdiction of the Subject Matter and Res Judicata* (1932) 80 U. OF PA. L. REV. 386.

29. United States v. Memphis Cotton Oil Co., 288 U. S. 62 (1933); Hurn v. Oursler, 289 U. S. 238 (1933); see 1 MOORE, FEDERAL PRACTICE (1938) 145-159; CLARK, CODE PLEADING (1928) 83.

30. D'Arcy v. Ketchum, 11 How. 165 (U. S. 1850); Thompson v. Whitman, 18 Wall. 457 (U. S. 1873).

31. American Surety Co. v. Baldwin, 287 U. S. 156 (1932); Stoll v. Gottlieb, 305 U. S. 165 (1938); *cf.* Davis v. Davis, 305 U. S. 32 (1938) (Virginia decree given effect of res judicata in District of Columbia court). State courts have made a few faltering steps toward giving subject matter jurisdiction the effect of res judicata. Chamblin v.

the *Chicot* doctrine[32] to require all courts to give full respect to each foreign judgment on the ground that it includes an implied finding of res judicata of jurisdictional issues, the prospects for national uniformity in treatment of judgments are indeed auspicious.

INCOME TAX ON TESTATOR'S ESTATE AT DISTRIBUTION OF GENERAL LEGACY*

As a rule, no income tax may be collected from a donor on a gratuitous transfer of property which has appreciated in value since its acquisition. The theory advanced in justification of this result is that there has been no "realization" of a capital gain within the Supreme Court's definition of "income."[1] An exception to this rule appears to have been formulated, however, in *William R. Kenan, Jr.*,[2] a recent decision of the Board of Tax Appeals involving the distribution of a legacy under a testamentary trust. In the *Kenan* case, the trust instrument provided that a named beneficiary, upon attaining the age of forty, should receive $5,000,000 or, at the option of the trustees, marketable securities in that amount. Distribution was largely made in securities which had increased in value nearly $2,000,000 since their acquisition by the trust at the time of the testator's death. The Board construed the distribution not as the transfer of a legacy, but as the discharge of the trust's pecuniary obligation to satisfy the beneficiary's rights in the trust fund.[3] Hence the gain to the trust, resulting from the release of other assets from this obligation to the extent that the distributed securities had appreciated in value since the time of the testator's death, was taxable income "realized" on a "sale or other disposition of property" within the meaning

Chamblin, 362 Ill. 588, 1 N. E. (2d) 73 (1936); *In re* Fischer's Estate, 118 N. J. Eq. 599, 180 Atl. 633 (1935).

32. The Court may not be willing to extend the *Chicot* rule to all cases. See Kalb v. Feuerstein, 60 Sup. Ct. 343, 346 (U. S. 1940).

*William R. Kenan, Jr., 40 B. T. A. No. 124, Oct. 26, 1939.

1. The Supreme Court has defined "income" as a gain derived and "realized" from property "provided it . . . include profit gained through a sale or conversion of capital assets." Eisner v. Macomber, 252 U. S. 189, 207 (1920), following Seligman, *Are Stock Dividends Income?* (1919) 9 AMER. ECON. REV. 517. Thus, income is defined in U. S. Treas. Reg. 101, Art. 111-1, as any gain "realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent."

2. 40 B. T. A. No. 124, Oct. 26, 1939, now on appeal to the Circuit Court of Appeals for the Second Circuit. 404 C. C. H. TAX SERV. 9057, 9066 (1940).

3. Following Suisman v. Eaton, 15 F. Supp. 113 (D. Conn. 1935), *aff'd per curiam sub nom.* Suisman v. Hartford-Connecticut Trust Co., Ex'r, 83 F. (2d) 1019 (C. C. A. 2d, 1936), *cert. denied*, 299 U. S. 573 (1936), *rehearing denied*, 299 U. S. 621 (1936), criticized in MONTGOMERY, FEDERAL TAXES ON ESTATES, TRUSTS AND GIFTS (1938) 40. Accord, I. T. 3316, INT. REV. BULL. No. 37 (1939) 6. *But cf.* O. D. 667, 3 CUM. BULL. 52 (1920).

of the Revenue Act.[4] Thus a technique of circumventing general prohibitions against taxing capital gains, which has been used to permit the taxation of a corporation's repurchase of its own bonds at a discount,[5] or of distribution of appreciated assets to satisfy the declaration of a stock dividend,[6] has now been introduced into the law governing the taxation of general legacies.

It is probable that a slight decrease in tax revenue will result from the adoption of this technique of characterizing the distribution of appreciated property in satisfaction of a general legacy as the discharge of a pecuniary obligation. In the case of a specific bequest, title to which may be said to have vested in the legatee at the time of the testator's death,[7] fair market value of the property at the time of decedent's death is taken as the basis for computing taxable gain on a subsequent realization by the legatee.[8] In

4. REVENUE ACT OF 1934, § 111, 48 STAT. 703, 26 U. S. C. § 111 (1934). The corresponding provision in the Revenue Act of 1938 is identical. 52 STAT. 484 (1938), INT. REV. CODE § 111 (1939).

5. United States v. Kirby Lumber Co., 284 U. S. 1 (1931). *But cf.* Transylvania R. R. v. Comm'r, 99 F. (2d) 69 (C. C. A. 4th, 1938), (1939) 17 N. C. L. REV. 305. The principle that a corporation realizes taxable income from the discharge of an indebtedness has now been enacted into law. Revenue Act of 1939, § 215(a), INT. REV. CODE § 22(b)(9) (1939). *Cf.* Betty Rogers v. Comm'r, 103 F. (2d) 790 (C. C. A. 9th, 1939).

6. Bacon-McMillan Veneer Co., 20 B. T. A. 556 (1930). *But cf.* General Utilities & Operating Co. v. Helvering, 296 U. S. 200 (1935), criticized in MAGILL, TAXABLE INCOME (1936) 233.

7. See U. S. Treas. Reg. 101, Art. 113(a)(5)-1; *cf.* Brewster v. Gage, 280 U. S. 327 (1930). The dissent in the *Kenan* case interpreted the legacy not as a pecuniary bequest, but as one of money or securities in the alternative, which became a legacy of securities once the trustee exercised his option. Suisman v. Eaton, 15 F. Supp. 113 (D. Conn. 1935), note 3 *supra,* and United States v. Kirby Lumber Co., 284 U. S. 1 (1931), note 5 *supra,* were said to be distinguished by the fact that in the *Kenan* case the consent of the beneficiary was wholly immaterial in determining the form that the distribution would take. William R. Kenan, Jr., 40 B. T. A. No. 124, at 5-6, Oct. 26, 1939. The majority indicated in reply that in the *Kenan* case, as in the *Suisman* case, there was no bequest of specific securities since the beneficiary had an equitable right to receive $5,000,000 in cash or its equivalent but no right to any specific assets. *Id.* at 3.

8. 52 STAT. 490 (1938), INT. REV. CODE § 113(a)(5) (1939). The phrase used to describe the basis under the 1934 and subsequent Acts, "time of such acquisition" (*i.e.,* by bequest, devise or inheritance), had proved so ambiguous when used in the earliest income tax laws — see, for example, Roebling v. Comm'r, 78 F. (2d) 444 (C. C. A. 3d, 1935) — that in § 113 of the 1928 and 1932 Acts, 45 STAT. 819 (1928), and 47 STAT. 199 (1932), Congress clearly distinguished between specific and general bequests, providing that for the latter, the basis should be value at the date of distribution to the legatee, and for the former, value at the date of the testator's death. However, Congress returned to "time of such acquisition" in the Revenue Act of 1934, 48 STAT. 706 (1934), perhaps in reliance (see Elizabeth G. Augustus, 40 B. T. A. No. 178, Dec. 20, 1939) on the interpretation given the phrase by the Supreme Court, for the 1926 Act, in Brewster v. Gage, 280 U. S. 327 (1930). "Time of such acquisition" is now being almost uniformly interpreted as time of testator's death. Elizabeth G. Augustus, *supra;* U. S. Treas. Reg. 101, Art. 113(a)(5)-1. This makes the apparent partial revival of the 1928 classification in the *Ewing* case, note 10 *infra,* particularly conspicuous. But while under the 1928 basis for property acquired by general legacy the capital increment between the date of the

the absence of the *Kenan* rule, the same basis would be applied to general legacies.[9] The result of taking this basis is that the tax burden for capital appreciation between the time of the testator's death and the time of realization on the property, including the appreciation arising while the property is in the hands of the trustee, is borne by the legatee alone. But under the *Kenan* doctrine, because of the "consideration" said to be supplied by the beneficiary through the discharge of the trust's pecuniary obligation to him, the beneficiary takes his share not as a legatee, but as a "purchaser." It is therefore implied from that case, and has since been held by the Board,[10] that the basis for computing the taxable gain to the beneficiary on a subsequent sale of the property is value at the time of "purchase," that is, the date of distribution by the executor or trustee. Thus the tax burden for the appreciation from the time of the testator's death until ultimate sale by the beneficiary is divided between the trust and the beneficiary; and this division, in view of the graduated rate of taxation provided under present tax laws, will probably net a smaller tax than that which would result from taxing the entire appreciation to one person.

The probable decrease in revenue, however, would seem to be no real objection to the imposition of an income tax on decedents' estates at the time of distribution of general legacies. Any necessary increase in revenue should be achieved through adjustment of the rate of taxation. The allocation of taxes should be determined according to the equitable position of the parties who will have to bear them.[11] In the *Kenan* case, the tax burden will ultimately fall on the remaindermen or residuary legatees. Since they are the ones who will benefit from the capital gain which is the occasion for the tax, such a result seems clearly equitable.

A complete statement of the principle of equitable allocation of tax burdens, however, would require not only that capital gains be taxed to the person in whose hands they arose, but also that no capital gain escape taxation. From this point of view, both statute and the *Kenan* case's specific holding have permitted an unjustified gap in leaving wholly free from income tax increases in the value of property between the time of acquisition by the testator and his death.[12] If the donor avoids any "realization" by sale or exchange in his lifetime, neither he nor his heirs or legatees need ever pay a tax on the

testator's death and the time of distribution was tax-free, that blind spot is now covered by the rule of the *Kenan* case.

9. Different considerations may apply where the property distributed by the trustee in satisfaction of a legacy has been acquired subsequent to the testator's death. The Board suggested by way of dictum in the *Kenan* case that this eventuality was an argument for taking value at the time of distribution, rather than time of death, as the basis for computing gain on the legatee's realization on the property. William R. Kenan, Jr., 40 B.T.A. No. 124, at 5, Oct. 26, 1939. But the circumstance of acquisition subsequent to decedent's death may reasonably be interpreted to give rise to a separate category, with value at the time of acquisition by the trustee as the basis. See Richard J. Reynolds, 41 B. T. A. No. 9, Jan. 10, 1940. The securities distributed in the *Ewing* case, note 10 *infra*, were all part of the original estate.

10. Sherman Ewing, 40 B. T. A. No. 138, Nov. 15, 1939.

11. See SIMONS, PERSONAL INCOME TAXATION (1938) 134-135.

12. See U. S. Treas. Reg. 101, Art. 162-1.

appreciation of the property in the donor's hands.[13] In the case of gifts inter vivos, some compensation for the non-taxability to the donor of the appreciation in value from time of acquisition to the time of gift has been provided by the requirement that the donee take cost to the donor as the basis in computing taxable gain on a subsequent sale of the donated property.[14] It has been suggested that cost to the testator should similarly be made the basis for measuring taxable gain on the realization of property by a legatee.[15] This device, however, has proved to be neither fair nor wholly effective. The equities would seem to dictate the imposition of a tax on donors and on decedents for the appreciation in value of property in their hands, rather than a later tax on that increment to be borne by the donees or legatees. Further, from the point of view of revenue, the requirement that the donee should take cost to donor as his basis has proved to be an inadequate substitute for an income tax imposed directly on donors. It is now relatively simple for the donor to escape to some extent the graduated rate of taxation by delegating to others, by means of gratuitous transfers, the power of sale and the concomitant liability to taxation — a liability at a lower rate than would have been imposed on the donor, had he retained the property to transact the sale himself.[16] A direct tax on donors would remove this power completely.[17]

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13. The estate and gift taxes are manifestly inadequate as compensations for the non-taxability of capital gains on gratuitous transfers, partly because of the large exemptions which they allow and partly because of their moderate rate of tax. See, relative to the gift tax, INT. REV. CODE §§ 1001(a) (schedule of rates), 1003(b) (annual exemption of $4000), and 1004(a) (exemption of $40,000) (1939). On the estate tax, see INT. REV. CODE §§ 810 (schedule of rates), 812(a) (exemption of $100,000), and 826(c) (exemption of $40,000 on proceeds of insurance) (1939).

14. 52 STAT. 490 (1938), INT. REV. CODE § 113(a)(2) (1939); Taft v. Bowers, 278 U. S. 470 (1929). *Cf.* Speer v. Duggan, 5 F. Supp. 722 (S. D. N. Y. 1933).

15. TWENTIETH CENTURY FUND, INC., FACING THE TAX PROBLEM (1937) 483, 491.

16. See Reginald Fincke, 39 B. T. A. No. 65, Mar. 3, 1939, where the Board, acknowledging that "it is . . . clear that [the petitioner] sold the stock to the three family trusts and his daughter at cost, having in mind that they in turn could sell the stock at a profit," and that "the petitioner's testimony shows that he deliberately refrained from selling this stock on the market, realizing a large profit himself and subjecting himself to income tax on that profit," nevertheless held that the petitioner realized no gain from the transaction. *Cf.* Janney v. Comm'r, 108 F. (2d) 564 (C. C. A. 3d, 1939), where it was held that the husband's losses could be used to offset his wife's gains, on their joint income tax return. But see Pierce v. Comm'r, 100 F. (2d) 397 (C. C. A. 2d, 1938).

17. The Controller in New York once attempted to impose an income tax on donors, on the theory that gifts were realizations of income comprehended within the statutory phrase "other disposition of property" [*cf.* note 4 *supra*], but his statutory construction was not accepted. Wilson v. Wendell, 196 App. Div. 596, 188 N. Y. Supp. 273 (3d Dep't 1921); Brewster v. Wendell, 196 App. Div. 613, 188 N. Y. Supp. 510 (3d Dep't 1921). The constitutional issue in the states is much less serious than that encountered by Congress, since the states have only "equal protection" and no Sixteenth Amendment with which to contend.

For suggestions on the treatment of capital losses, see SIMONS, *op. cit. supra* note 11, at 212.

Such a direct tax, however, might be subject to constitutional attack on the ground that a gratuitous transfer does not give rise to taxable "income" under the Supreme Court's early and rigid definition of "income" as gain severed from capital.[18] One escape from this difficulty would be for the court to discard its view that there is no income until realization. There is nothing inevitable about the realization criterion. Four justices dissented from the decision which established it, and many writers believe a truer definition of income to be the net accretion to one's economic power between two points of time.[19] Under this view, all capital gains, whether realized or not, constitute income, and realization is no more than a convenient occasion for a reckoning between an individual and the taxing authorities.[20] A gratuitous transfer, no less than a sale, would seem to qualify as such an occasion.[21] However, it is quite possible that a tax on donors might be sustained without departing from the formal realization criterion. Numerous decisions have shown that the term "realization" is a very pliant one.[22] Of course, if the holding of the *Kenan* case, that pecuniary bequests satisfied in appreciated property are sufficiently unlike specific bequests to warrant a significant differentiation in treatment for income tax purposes, is sound, the case constitutes an orthodox application of the realization doctrine. But if it is merely a colorable rationalization to justify imposition of an income tax on what is really a gratuitous transfer, it is difficult to perceive why a similar rationalization could not be extended to other sorts of gratuitous transfers. On this view, the case may suggest a possible rationale for sustaining an income tax on donors on the gratuitous transfer of property which has appreciated in value since its acquisition.

18. See note 1 *supra.*

19. HAIG, *The Concept of Income* in THE FEDERAL INCOME TAX (Col. Univ. Lectures 1921) 7. *Cf.* REPORT OF SUBCOMMITTEE OF COMMITTEE ON WAYS AND MEANS ON PROPOSED REVISION OF THE REVENUE LAWS, 75th Cong., 3d. Sess. (1938) 30: "From the standpoint of taxation, the kind of income that is relevant and significant is the income that measures taxpaying ability." See in general, Wueller, *Concepts of Taxable Income II: The American Contribution* (1938) 53 POL. SCI. Q. 557.

20. SIMONS, *op. cit. supra* note 11, at 100. *Cf.* Powell, *Income from Corporate Dividends* (1922) 35 HARV. L. REV. 363, 376.

21. While an income tax on annually accrued, unrealized gains and losses might be cumbersome and inadvisable, SIMONS, *op. cit. supra* note 11, at 169, there would be few, if any, novel difficulties encountered in collecting an income tax on gratuitous transfers of property. Both the difficulty of valuation and the possibility of "forced liquidation" to raise cash for payment of the tax are familiar under other sections of the tax laws. See INT. REV. CODE § 113 (1939).

22. See MAGILL, *op. cit. supra* note 6, at 392 *et seq.*

APPORTIONMENT BETWEEN LIFE TENANT AND REMAINDERMAN OF PROCEEDS OF LEASE CANCELLATION*

THE apportionment between life tenant and remainderman of proceeds derived from the cancellation of a lease is governed by inconsistent legal principles.[1] The receipt of such proceeds may result from a simple cancellation or from a cancellation accompanied by the grant of a new lease of a longer term. Although courts distinguish between the two situations, the body of doctrine applied in both is scarcely satisfactory. The inadequacy of the existing law controlling simple cancellations is graphically illustrated by a recent New York case.[2]

A testator created a trust, with income to his wife and children, remainder to the issue of the children. The corpus was composed, in part, of certain real property which the testator, five years before his death, had leased for a term of twenty-one years. In the ninth year of the lease, the lessee, with court approval, paid the trustee a lump sum for the surrender and cancellation of the lease. The trustee then asked the Surrogate Court for instructions as to the proper disposition of this sum. The life tenants contended that the payment was income and should be immediately distributed as such, while the remaindermen insisted that the proceeds should be allocated either entirely or in part to the principal account. The court, however, chose a middle ground. It directed the trustee to divide the sum into as many installments as there were years remaining until the expiration date of the lease and to pay one installment in each of these years as income from the trust.[3]

The court was guided by precedent which seems to turn on whether or not the person to whom the lessee delivered the money bore a fiduciary relationship to the remainderman. Where this relationship is discovered, the court usually directs the payment of the sum in installments over the balance of the cancelled lease; in the absence of such a connection, the entire sum is awarded to the life tenant as immediate income.[4]

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* *In re* O'Keeffe's Estate, 15 N. Y. S. (2d) 201 (Surr. Ct. 1939).

1. This Note is concerned only with the situation which arises when the settlor has not defined the rights of the beneficiaries to the proceeds from cancellation of a lease otherwise than providing that income from the trust is payable to one beneficiary, and the principal is payable to another beneficiary upon the death of the first. For the situation where the testator provides otherwise, see 2 SCOTT, TRUSTS (1939) § 233.5.

2. *In re* O'Keeffe's Estate, 15 N. Y. S. (2d) 201 (Surr. Ct. 1939), (1940) 24 MINN. L. REV. 442.

3. Should the trust terminate before the expiration date of the lease, the unpaid installments would become due and payable at once to the remainderman.

4. The rule arose in the English courts. In *In re* Hunloke's Settled Estates, [1902] 1 Ch. 941, 71 L. J. Ch. 530, a life tenant to whom a lessee had paid a settlement was allowed to retain the sum as immediate income. Parker, J., in *In re* Rodes, [1909] 1 Ch. 815, 78 L. J. Ch. 434, a similar case, ordered an apportionment of the sum over the remainder of the cancelled lease. He distinguished the previous case on the ground that the life tenant in that case had not been a fiduciary, while, in the case before him, the life tenant-payee was a fiduciary under the Settled Land Acts, 1882, 45 & 46 VICT., c. 38, § 53, and hence could not retain the sum. See WOODFALL, LANDLORD AND TENANT (Blundell's ed. 1939) 35. Importance is attached to the absence of a fiduciary relationship be-

In the light of this rule's shortcomings, the court must have set it up to justify rather than determine the conclusion. Since some fiduciary relationship to the remainderman is implicit in the status of life tenant and trustee,[5] the two possible payees, the establishment of a standard of "fiduciary relationship" without definitional qualification is of no help in solving the problem.[6] And even if the standard were reduced to more workable terms, it would still bear no logical connection with the question of who should be the ultimate recipient of the money.[7]

That so arbitrary a rule is not conducive to an equitable result seems apparent from examination of the alternative dispositions which it leaves available. Where cancellation is the sole consideration for the settlement, neither disbursement to the life tenant as immediate income nor apportionment over the remainder of the cancelled lease will fairly compensate the beneficiaries for their respective losses.[8] After cancellation the particular property will, of course, produce no income until a new tenant is obtained. Even thereafter, a partial loss of income owing to a reduced rental will probably occur, for the willingness of the previous lessee to pay a large settlement indicates that the cancelled lease demanded a rental considerably in excess of the current lease-value of the property.[9]

Since it appears at first blush that both losses will fall on the life tenant, payment of the entire settlement to him, as some cases suggest,[10] might seem fair. But actually, an immediate distribution of the entire sum to the life tenant would be inequitable; the life tenant might die at once,[11] and the

tween payee and remainderman in *In re* Penrhyn's Settlement, [1922] 1 Ch. 500, 91 L. J. Ch. 490, and to its presence in the instant case, and, by implication, in Johnson v. Brink, 271 Mass. 521, 171 N. E. 717 (1930). See Note (1939) 121 A. L. R. 900. But see Lang v. Mississippi Valley Trust Co., 343 Mo. 979, 124 S. W. (2d) 1198 (1938), which looks to the relationship between life tenant and remainderman, rather than between payee and remainderman; it stands as the only exception to a tenuous rule.

5. See Warfield v. Bixby, 51 F. (2d) 210, 214 (C. C. A. 8th, 1931) ("The relation of a life tenant to a remainderman . . . is that of a quasi-trustee.")

6. The payee who bears a "fiduciary relationship" to the remainderman cannot treat the settlement as immediate income to the life tenant because to do so, it is reasoned, would be a breach of his fiduciary duty. See *In re* Rodes, [1909] 1 Ch. 815, 818, 78 L. J. Ch. 434, 436. The rule fails to state which of the common fiduciary relationships include the duty to apportion over the remainder of a cancelled lease.

7. The fundamental equities of the remainderman's claim to the settlement are certainly not augmented by a delivery of the money to the trustee rather than to the legal or equitable life tenant.

8. The settlement is most equitably distributed between life tenant and remainderman if it restores both beneficiaries to the positions they would have been in had not the lease been cancelled; or, in other words, if it compensates each beneficiary for his losses.

9. The settlement does not *necessarily* prove a reduced rental; the lease might have contained restrictions or other provisions which would seriously impair the rental value of the property to the particular lessee, but which would not similarly impair its value to another.

10. Lang v. Mississippi Valley Trust Co., 343 Mo. 979, 124 S. W. (2d) 1198 (1938); *In re* Hunloke's Settled Estates, [1902] 1 Ch. 941, 71 L. J. Ch. 530; *In re* Penrhyn's Settlement, [1922] 1 Ch. 500, 91 L. J. Ch. 490.

11. If the life expectancy of the life tenant exceeds in years the unexpired term of the lease, it is probable that he will suffer the entire loss. However, it is but a mere

remainderman would not be indemnified for the unproductive period or the period of reduced rentals occurring after the life tenant's death.[12] The solution reached in this[13] and a few other cases[14] — a distribution of the consideration over the remainder of the cancelled lease — would compensate the remainderman for any losses he might suffer, but it would deprive the life tenant of an adequate income while a new tenant was being found.[15] The greater brunt of the loss is thus placed upon the life estate despite his efforts in negotiating a successful settlement. Hence neither of these dispositions will reach a completely fair result.

The settlement could be distributed equitably, however, by providing from it a reasonable income to the life tenant while the property remains unproductive, and then, when a new lessee is obtained, by apportioning the remainder of the sum over the unexpired term of the cancelled lease.[16] For the proposed payments to the life tenant during the unproductive period, both legal support and practical rules for administration may be found in the cases and state statutes which supervise the apportionment of the proceeds of sales of unproductive trust property.[17] The states' rules vary as to the amount of

probability, and the settlement should not be given to the life tenant even in cases where, as here, the life tenants are children and the lease, when cancelled, had but 12 years to run.

12. See *In re* O'Keeffe's Estate, 15 N. Y. S. (2d) 201, 204 (Surr. Ct. 1939).

13. *In re* O'Keeffe's Estate, 15 N. Y. S. (2d) 201 (Surr. Ct. 1939).

14. *In re* Rodes, [1909] 1 Ch. 815, 78 L. J. Ch. 434; *accord*, Johnson v. Brink, 271 Mass. 521, 171 N. E. 717 (1930).

15. In Johnson v. Brink, 271 Mass. 521, 171 N. E. 717 (1930), the cancelled lease was replaced at once by a new lease at a lower rental; the life tenant hence did not experience an unproductive period, and apportionment of the settlement over the remainder of the cancelled lease was proper compensation for the reduced rental. In *In re* O'Keeffe's Estate, 15 N. Y. S. (2d) 201 (Surr. Ct. 1939) and *In re* Rodes, [1909] 1 Ch. 815, 78 L. J. Ch. 434, it is possible that the properties were leased immediately after the lease cancellations, in which case the apportionments ordered would be satisfactory, as in Johnson v. Brink, *supra*. But the court in each case fails to mention an immediate re-lease. It is also possible in the *O'Keeffe's* and *Rodes* cases that the properties in question were but a small part of the total trust res; if so, an unproductive period would not seriously inconvenience the life tenants. The existence of other sources of income, however, should not destroy the life tenant's rights to a reasonable income from these particular properties.

16. Cases advocating apportionment over the remainder of the cancelled lease, which would lend support to the latter part of the proposed distribution, are: *In re* O'Keeffe's Estate, 15 N. Y. S. (2d) 201, 204 (Surr. Ct. 1939); Johnson v. Brink, 271 Mass. 521, 529, 171 N. E. 717, 720 (1930); *In re* Rodes, [1909] 1 Ch. 815, 818-9, 78 L. J. Ch. 434, 436. See (1937) 46 YALE L. J. 872. The proceeds of the cancellation might be invested pending the proposed distributions to the beneficiaries; interest on such investments would, of course, be treated as income from the trust in the year in which it accrues.

17. The life tenant is generally allowed to recover income for the unproductive period between default of a mortgage and sale of the foreclosed property, on the theory that the trustee, by failing to convert the defaulted mortgage into productive investments, has effected an equitable conversion. By analogy, the trustee's cancellation of the lease and subsequent retention of the property might also be an equitable conversion. On the subject of apportionment of proceeds of sales of unproductive trust assets generally, see 2 SCOTT, TRUSTS (1939) §§240-1.3; 4 BOGERT, TRUSTS AND TRUSTEES (1935) §825; RESTATEMENT, TRUSTS (1935) §240; UNIFORM PRINCIPAL AND INCOME ACT §11; Bran-

compensation to be given to the life tenant; perhaps the most equitable solution would be to pay the life tenant, during the period of unproductivity, a portion of the settlement equal to the current rental value of the property.[18]

Manifestly, this situation falls within a category distinct from that in which a lessee makes a payment not only for cancellation of his lease, but also for the grant of a new, extended one.[19] Under the latter, there is no possibility of an unproductive period, and, generally, no question of a smaller rental in the future. Since the lessee would have been willing, had he not made the settlement, to pay a higher rental in the new lease, the settlement actually represents advance rent,[20] which in the absence of statute is not apportionable.[21] Today, however, more than half the states recognize the unfairness of treating advance rent as immediate income for the life tenant and have made statutory provision for its apportionment between life tenant and remainderman.[22] Under these statutes courts have approved apportionment of the settlements accompanying renewals, but have accepted the old lease as the basis.[23] Such treatment is clearly inconsistent, for if the settle-

dis, *Trust Administration: Apportionment of Proceeds of Sale of Unproductive Land and of Expenses* (1931) 9 N. C. L. REV. 127; Comment (1930) 40 YALE L. J. 275; (1937) 5 U. OF CHI. L. REV. 122.

18. Since the property is idle, the valuation would presumably be based upon the current rentals of similar property. But see 2 SCOTT, TRUSTS (1939) § 241.3, indicating that an amount equal to the rental required in the cancelled lease, or an amount equal to the current return on trust investments of the same value as the property might be more easily justified.

19. This was the situation in *In re* Archambault's Estate (No. 2), 232 Pa. 347, 81 Atl. 314, 36 L. R. A. (N.S.) 637 (1911); *In re* Wix, [1916] 1 Ch. 279, 85 L. J. Ch. 192; Campbell v. Kawananakoa, 51 Haw. 500 (1930); Malcom v. Comm'r, 97 F. (2d) 381 (C. C. A. 2d, 1938). *Cf.* Johnson v. Brink, 271 Mass. 521, 171 N. E. 717 (1930) (new short-term lease, at lower rental).

20. The income under the extended lease is thus reduced by the amount of the prepayment, even when the new rental is higher than under the old lease. See *In re* Wix, [1916] 1 Ch. 279, 288, 85 L. J. Ch. 192, 196. *But cf. In re* Archambault's Estate (No. 2), 232 Pa. 347, 350, 81 Atl. 314, 315, 36 L. R. A. (N.S.) 637, 639 (1911), "The remaindermen have not been prejudiced in any way by the transaction." This latter view is apparently approved in Lang v. Mississippi Valley Trust Co., 343 Mo. 979, 986, 124 S. W. (2d) 1198, 1202 (1938) and in *In re* O'Keeffe's Estate, 15 N. Y. S. (2d) 201, 203 (Surr. Ct. 1939).

21. Under the common law rule forbidding the apportionment of advance rent, the entire amount is treated as immediate income for the life tenant. See RESTATEMENT, PROPERTY (1936) § 120, Comment *c*; *In re* Archambault's Estate (No. 2), 232 Pa. 347, 349, 81 Atl. 314, 315, 36 L. R. A. (N.S.) 637, 639 (1911). This rule has been vigorously criticized. See 2 SCOTT, TRUSTS (1939) § 235.

22. See RESTATEMENT, PROPERTY (1936) § 120, comment *d* (for a list of states with apportionment-of-rent statutes). UNIFORM PRINCIPAL AND INCOME ACT § 4 provides for the apportionment of rent.

23. *In re* Wix, [1916] 1 Ch. 279, 85 L. J. Ch. 192; Malcom v. Comm'r, 97 F. (2d) 381 (C. C. A. 2d, 1938). Apportionment over the remainder of the old lease has been sanctioned in other cases. See Campbell v. Kawananakoa, 31 Haw. 500 (1930) (no mention of common law); Johnson v. Brink, 271 Mass. 521, 171 N. E. 717 (1930) (unexpired term of old lease same as term of new lease); *In re* Archambault's Estate

ment is advance rent, it is related to the new lease and should be apportioned accordingly.[24] But more important is the fact that this alternative, clearly permissible under the statute, is the equitable solution, since it would compensate the remainderman for the reduced rental which he would receive should the life tenant die during the term of the new lease.

(No. 2), 232 Pa. 347, 81 Atl. 314, 36 L.R.A. (N.S.) 637 (1911) (life tenant failed to appeal lower court decision awarding apportionment over unexpired term of cancelled lease).

24. A court could order the purchase of an annuity, payable to that beneficiary who may be entitled to income from the trust at the time each installment of the annuity falls due.